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# THE FRAGMENTED REGULATION OF INVESTMENT ADVICE: A CALL FOR HARMONIZATION

*Christine Lazaro\* & Benjamin P. Edwards\*\**

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## I. INTRODUCTION

Decades of short-term thinking and regulatory fixes created the bewilderingly complex statutory and regulatory structures governing the giving of personalized investment advice to retail customers.<sup>1</sup> Although deeply flawed, the current systems remain entrenched because of the difficulties inherent in making radical alterations.<sup>2</sup> Importantly, the current patchwork systems do not seem to serve retail customers particularly well. Retail customers tend to make predictable and costly mistakes in allocating their assets.<sup>3</sup> Some of this occurs because many investors lack basic financial literacy.<sup>4</sup> A recent study released by the staff of the Securities and Exchange Commission (the “Commission”) on financial literacy among investors (the “Literacy Study”) highlights some frightening findings.<sup>5</sup> The Literacy Study documents that many investors struggle to protect them-

1. For purposes of this Article, “retail customer” shall be defined as it is in section 913(g)(2) of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010: “a natural person, or the legal representative of such natural person, who (A) receives personalized investment advice about securities from a broker, dealer, or investment adviser; and (B) uses such advice primarily for personal, family, or household purposes.” Dodd-Frank Wall Street Reform and Consumer Protection (Dodd-Frank) Act, Pub. L. No. 111-203, § 913(g), 124 Stat. 1376, 1824-30 (2010) (codified as 15 U.S.C. § 80b-11(g)(2) (2012)).

2. See COMM. ON COMP. PRACTICES, U.S. SEC. & EXCH. COMM’N, REPORT OF THE COMMITTEE ON COMPENSATION PRACTICES 3 (1995), available at <http://www.sec.gov/news/studies/bkrcomp.txt> (explaining that the Committee would not recreate the status quo and lamenting that “the current compensation system is too deeply rooted to accommodate radical alteration in the near-term.”).

3. See, e.g., Andrea Frazzini & Owen A. Lamont, *Dumb Money: Mutual Fund Flows and the Cross-Section of Stock Returns*, 88 J. FIN. ECON. 299, 319 (2008) (concluding that “individual investors have a striking ability to do the wrong thing.”).

4. OFFICE OF INVESTOR EDUC. & ADVOCACY, U.S. SEC. & EXCH. COMM’N, STAFF STUDY REGARDING FINANCIAL LITERACY AMONG INVESTORS (2012), iii [hereinafter LITERACY STUDY], available at <http://www.sec.gov/news/studies/2012/917-financial-literacy-study-part1.pdf>.

5. *Id.*

selves against fraud and do not understand basic concepts such as diversification, investment costs, inflation, or compound interest.<sup>6</sup> Certain subgroups, “including women, African-Americans, Hispanics, the oldest segment of the elderly population, and those who are poorly educated, have an even greater lack of investment knowledge than the general population.”<sup>7</sup> Much has been said about the role of financial literacy in protecting investors.<sup>8</sup> Investors may also be protected through legislation and regulation. Following the Great Depression, the federal securities laws were enacted for precisely this purpose.<sup>9</sup> But over time, the distinctions that once existed between the different professionals offering different forms of investment advice have disappeared, blurring the lines between existing regulatory structures.

Amidst these muddled regulatory structures, many different persons provide advice and growing ranks of self-described “financial advisers” now profit from advising retail customers. According to the Financial Industry Regulatory Authority (“FINRA”), “financial adviser” and many similar titles are simply “generic terms or job titles, and may be used by investment professionals who may not hold any specific credential.”<sup>10</sup> The person behind the title may actually be a stockbroker, investment adviser, insurance salesperson, accountant, lawyer, or some other financial professional—each of whom may owe different duties to the investor.<sup>11</sup> In many cases, a single financial adviser may wear several hats. In each role, the financial adviser owes different duties to retail customers depending on the type of compensation being received, product sold, and locality.<sup>12</sup> Retail customers meet with financial advisers because they want personalized

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6. *Id.* at viii.

7. *Id.*

8. See, e.g., Lauren E. Willis, *Against Financial-Literacy Education*, 94 IOWA L. REV. 197 (2008) (describing the failures of the financial-literacy approach). Troublingly, many investors do not recognize their own financial illiteracy. These failures may occur because of the Dunning-Krueger effect, which explains that people tend to grossly overestimate their own knowledge because they lack the information and metacognitive skills necessary to recognize their deficits. See Joyce Ehrlinger et al., *Why the Unskilled Are Unaware: Further Explorations of (Absent) Self-Insight Among the Incompetent*, 105 ORGANIZATIONAL BEHAV. & HUM. DECISION PROCESSES 98, 99 (2008); Justin Kruger & David Dunning, *Unskilled and Unaware of It: How Difficulties in Recognizing One's Own Incompetence Lead to Inflated Self-Assessments*, 77 J. PERSONALITY & SOC. PSYCHOL. 1121, 1127 (1999). In 2012, the FINRA Investor Education Foundation released its FINANCIAL CAPABILITY STUDY and found, among other things, that despite “low levels of financial literacy . . . Americans tend to have positively biased self-perceptions of their financial knowledge.” FIN. INDUS. REGULATORY AUTH. INVESTOR EDUC. FOUND., FINANCIAL CAPABILITY IN THE UNITED STATES: REPORT OF FINDINGS FROM THE 2012 NATIONAL FINANCIAL CAPABILITY STUDY 29 (2013).

9. See, e.g., H.R. REP. NO. 73-85 (1933).

10. *Rules and Resources*, FIN. INDUS. REGULATORY AUTH., <http://www.finra.org/Investors/ToolsCalculators/ProfessionalDesignations/RulesandResources/> (last visited Oct. 4, 2014).

11. *Id.*

12. See *infra* Part III for a discussion of these differences.

advice properly tailored to their situation.<sup>13</sup> But retail customers do not generally understand the different systems of oversight, different standards of care, or the associated legal implications.<sup>14</sup> Instead, retail customers simply expect that advice given will be in their best interest.<sup>15</sup> This expectation is misplaced—the law does not require that all financial advisers provide advice in their clients’ best interests.<sup>16</sup> To remedy this, many advocates have pressed to hold certain financial advisers providing investment advice, Brokers<sup>17</sup> and Advisers,<sup>18</sup> to the same fiduciary standards. Reflecting these efforts, Section 913 of Title IX of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (“Dodd-Frank”) contains a provision directing the Commission to study the standards for providing personalized investment advice about securities to retail customers.<sup>19</sup> After completing this study, the Commission’s staff recommended establishing a uniform, albeit limited, fiduciary standard for advice about securities to retail customers.<sup>20</sup> But in the face of opposition, the Commission has not yet enacted a rule.

While more uniform standards for Brokers and Advisers would do much good, insurance products like equity-indexed annuities blur the lines

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13. See SEC STAFF, STUDY ON INVESTMENT ADVISERS AND BROKER-DEALERS i (2011) [hereinafter FIDUCIARY STUDY], available at <http://www.sec.gov/news/studies/2011/913studyfinal.pdf>. For decades, financial services firms have advertised their services and stressed that consumers should come to them for advice. See Arthur B. Laby, *Selling Advice and Creating Expectations: Why Brokers Should Be Fiduciaries*, 87 WASH. L. REV. 707, 756 (2012) (documenting that brokerage firms have long advertised that they provide personalized advice). To be sure, if retail customers knew what products to buy, they would not need to meet with investment professionals to buy it; online brokerages execute trades cheaply and efficiently.

14. See FIDUCIARY STUDY, *supra* note 13; see also Christine Lazaro, *The Future of Financial Advice: Eliminating the False Distinction Between Brokers and Investment Advisers*, 87 ST. JOHN’S L. REV. 381, 411 (2013) (“More and more investors do not even realize that there is a distinction between brokers and investment advisers.”).

15. See FIDUCIARY STUDY, *supra* note 13.

16. Christine Lazaro, *Fiduciary Duty - Now and in the Future*, 17 NO. 2 PIABA B.J. 129, 132 (2010) (“[T]he suitability standard requires that a recommendation merely be suitable for a customer, not necessarily that it be in the customer’s best interest.”).

17. “Broker” is defined as “any person engaged in the business of effecting transactions in securities for the account of others.” 15 U.S.C. § 78c(a)(4)(A). A “Dealer” is “any person engaged in the business of buying and selling securities (not including security-based swaps, other than security-based swaps with or for persons that are not eligible contract participants) for such person’s own account through a broker or otherwise.” 15 U.S.C. § 78c(a)(5)(A). For this Article, the term “Broker” encompasses those individuals acting as both brokers and dealers, or those individuals commonly known as stockbrokers.

18. “Adviser” is defined in relevant part as “any person who, for compensation, engages in the business of advising others, either directly or through publications or writings, as to the value of securities or as to the advisability of investing in, purchasing, or selling securities.” 15 U.S.C. § 80b-2(a)(11).

19. Dodd-Frank Act, Pub. L. No. 111-203, § 913, 124 Stat. 1376, 1824-30 (2010) (codified as 15 U.S.C. § 78o (2012)).

20. See FIDUCIARY STUDY, *supra* note 13, at ii.

between securities and insurance products, presenting novel regulatory challenges for the regulation of investment advice.<sup>21</sup> With more than \$224.7 billion in asset-value as of 2012,<sup>22</sup> equity-indexed annuity contracts comprise a large class of financial products that do not fit neatly into pre-existing legal and regulatory categories.<sup>23</sup> Equity-indexed annuities have also garnered complaints of abusive sales practices,<sup>24</sup> alleging in particular that sellers do not adequately explain these complicated products to purchasers.<sup>25</sup> Critics contend that the dazzling sales numbers have been driven by “outsize commissions” funded by high surrender charges and long asset lock-up provisions, which make the products less suitable for seniors or others who need to be able to access their money in case of emergencies.<sup>26</sup> Responding to these concerns in 2008, Commission Chairman Christopher Cox noted that 45% of investor complaints involved seniors and that equity-indexed annuities were “among a handful of products most often involved in senior investment fraud.”<sup>27</sup>

The need for competent investment advice has never been greater. While persons of every generation seek advice, the increasingly vulnerable Baby Boomer generation now controls approximately \$13 trillion in household investible assets.<sup>28</sup> Complicating this issue, the investing and retirement world has changed from traditional defined benefit pension plans to defined contribution savings plans, such as 401(k) plans.<sup>29</sup> As a

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21. See Indexed Annuities and Certain Other Insurance Contracts, Securities Act Release Nos. 33-8996, 34-59221, 74 Fed. Reg. 3138-01, 8 (Jan. 8, 2009). The product has also been known as a fixed indexed annuity. For ease of reference, this Article refers to the product as an “equity-indexed annuity.” See *Id.*

22. INSURED RET. INST., IRI 2013 FACT BOOK 164 (12th ed. 2013) [hereinafter IRI FACTBOOK].

23. With an equity-indexed annuity, the insurance company commits to credit the purchaser an amount derived, in part, from some equity, bond, or other securities index’s future performance. *Id.* at 11. In this sense, the product may be categorized as a derivative for retail customers because it is a financial agreement between two parties, with the value of the contract to be determined by something that occurs in the future. Robert O’Harrow, *A Primer on Financial Derivatives*, WASH. POST, Apr. 21, 2010, at A13. For a more detailed description of an equity-indexed annuity, see *infra* Part IV(B).

24. See Indexed Annuities and Certain Other Insurance Contracts, *supra* note 21, at 10.

25. *Id.*

26. *Id.*

27. Chairman Christopher Cox, Statement at Open Meeting on Equity-Indexed Annuities (Jun. 25, 2008), [http://www.sec.gov/news/speech/2008/spch062508cc\\_annuity.htm](http://www.sec.gov/news/speech/2008/spch062508cc_annuity.htm).

28. See FIDUCIARY STUDY, *supra* note 13, at 93–94.

29. Edward A. Zelinsky, *The Defined Contribution Paradigm*, 114 YALE L.J. 451, 453 (2004) (“Pension cognoscenti have frequently remarked on the stagnation of defined benefit pensions and the concomitant rise of defined contribution plans.”).

result, Americans now find themselves making more investment decisions without a pension plan to fall back on.<sup>30</sup>

This Article examines the different systems of oversight governing investment advice and argues that an Investment Advice Act focused on harmonizing standards for investment advice is the best solution to address the shortcomings of the existing regulatory systems. Part II discusses the existing statutory and regulatory structures and reviews the history of securities and insurance regulation. Part III examines the different standards of care that financial professionals may owe depending on the type of product they sell and their relationship to the customer. Part IV discusses equity-indexed annuities as an example of a product that has blurred the boundaries between securities and traditional insurance products and the regulatory, judicial, and Congressional battles for supremacy. Part V proposes a more elegant solution—reducing regulatory overlap by empowering the Commission to regulate the giving of personalized retail investment advice involving securities or insurance, generally.

## II. THE CURRENT ARCHITECTURE

Different statutory and regulatory systems govern the interrelated securities and insurance industries. While the 2008 financial crisis exposed just how interrelated these markets are today, the fragmented regulatory architecture has not kept pace with financial innovation. Part II describes the existing dual federal and state system for securities regulation and the state-centered scheme for insurance regulation to provide a foundation for the proposed solution for regulating personalized retail investment advice.

### A. Dual Federal & State Securities Regulation

#### 1. Initial Regulation by the States and the Beginning of Federal Regulation

Securities regulation within the United States began at the state level. State laws creating liability for securities fraud, known as blue sky laws, first appeared in the 1910s.<sup>31</sup> In addition to requiring robust disclosures, state blue sky laws also often regulated the quality of the securities offered on a merit basis—giving state officials the power to examine whether the securities were substantively suitable for sale.<sup>32</sup> These new laws were initially controversial, but in 1917 the Supreme Court upheld state securities statutes as constitutional in *Hall v. Geiger-Jones Co.*, effectively recogniz-

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30. See JACOB S. HACKER, *THE GREAT RISK SHIFT: THE ASSAULT ON AMERICAN JOBS, FAMILIES, HEALTH CARE, AND RETIREMENT AND HOW YOU CAN FIGHT BACK*, Oxford, U.P. (2006), for a thorough discussion of the changing risk dynamics.

31. See Michael A. Perino, *Fraud and Federalism: Preempting Private State Securities Fraud Causes of Action*, 50 STAN. L. REV. 273, 279–80 (1998) (describing history of blue sky laws); Jonathan R. Macey & Geoffrey P. Miller, *Origin of the Blue Sky Laws*, 70 TEX. L. REV. 347, 359, 361 (1991) (describing the origin of state blue sky laws).

32. 1 THOMAS LEE HAZEN, *TREATISE ON THE LAW OF SECURITIES REGULATION* § 1.2[2] (6th ed. 2009) [hereinafter HAZEN, *SECURITIES REGULATION*].



ing that states could validly regulate securities offerings occurring within their borders.<sup>33</sup> However, because securities could be sold in one state and then mailed into another, states lacked any effective power to regulate the national securities market.<sup>34</sup> Even though most states soon passed their own blue sky laws, state-by-state regulation proved ineffective.<sup>35</sup>

Federal securities regulation in the interest of consumer protection began only in the aftermath of the Great Depression. In 1933, Congress passed the Securities Act of 1933 (the “Securities Act”).<sup>36</sup> President Franklin Roosevelt encouraged Congress to pass the legislation and add to “the ancient rule of caveat emptor the further doctrine, ‘Let the seller also beware.’”<sup>37</sup> The law created a number of private remedies for investors purchasing securities governed by the Securities Act and has been characterized as the first true consumer protection law because it represented a movement towards *caveat vendor*.<sup>38</sup>

Unlike state securities regulation, which would often include a merit regulation component, the federal securities laws focus principally on disclosure.<sup>39</sup> The Securities Act requires an issuer to fully disclose all material facts about the offering so that investors may make their own decisions about a particular security’s value.<sup>40</sup> The federal securities laws apply to products falling within their definition of security,<sup>41</sup> which Section 2(a)(1) of the Securities Act defines as including:

any note, stock, treasury stock, security future, security-based swap, bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit-sharing agreement, collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit for a security, fractional undivided interest in oil, gas, or other mineral rights, any put, call, straddle, option, or privilege on any security, certificate of deposit, or group or index of securities (including any interest therein or based on the value thereof), or any put, call, straddle, option, or privilege entered into on a national securities exchange relating to foreign currency, or, in general, any interest or instrument commonly known as a “security”, or any certificate of interest or participation in, temporary or interim certificate for, receipt for, guarantee of, or warrant or right to subscribe to or purchase, any of the foregoing . . . .<sup>42</sup>

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33. *See* *Hall v. Geiger-Jones Co.*, 242 U.S. 539, 539 (1917); *see also* Macey, *supra* note 31, at 388.

34. *Id.*

35. *Id.*

36. The Securities Act of 1933, Pub. L. No. 73-22, 48 Stat. 74 (1933) (codified as amended at 15 U.S.C. §§ 77a-77aa (2012)).

37. H.R. REP. NO. 73-85, at 2 (1933).

38. HAZEN, SECURITIES REGULATION, *supra* note 32, § 1.2[3].

39. *Id.* at 35.

40. *Id.* § 1.2[3][A], at 36.

41. *See Id.* § 1.6[0]. (“The primary jurisdictional trigger for the federal securities laws depends on the existence of a security.”).

42. 15 U.S.C. § 77b(a)(1) (2012).



This broad statutory definition reflects the expansive scope of federal securities regulation.<sup>43</sup>

In applying the Securities Act's definition, courts broadly construe the term "investment contract." In *SEC v. W.J. Howey Co.*, the Supreme Court defined the term "investment contract" as a "contract, transaction or scheme whereby a person (i) invests his money (ii) in a common enterprise and (iii) is led to expect profits (iv) solely from the efforts of the promoter or a third party."<sup>44</sup> This broad definition has been found to encompass many different types of schemes—including even the sale of earthworms to be repurchased at a later date.<sup>45</sup> Despite this broad definition and judicial willingness to apply the securities laws broadly, the Securities Act explicitly excludes certain investment contracts from the definition of "security" under the Securities Act. In particular, Section 3(a)(8) explicitly excludes "[a]ny insurance or endowment policy or annuity contract or optional annuity contract, issued by a corporation subject to the supervision of the insurance commissioner, bank commissioner, or any agency or officer performing like functions, of any State or Territory of the United States or the District of Columbia[.]"<sup>46</sup> As discussed in greater detail below, the scope of these exclusions has led to significant regulatory boundary disputes.

Over time, the federal securities laws expanded to address the protection of investors and how national securities markets function. Shortly after passing the Securities Act, Congress passed the Securities Exchange Act of 1934 (the "Exchange Act"). The Exchange Act created the Commission and empowered it to regulate the national securities markets and to police the behavior of Brokers and broker-dealers selling securities to the investing public.<sup>47</sup> In 1938, Congress tweaked the structure again and passed the Maloney Act, amending the Exchange Act to allow self-regulatory organizations, such as FINRA, to assist the Commission in overseeing Brokers and broker-dealers.<sup>48</sup> In 1940, the Commission gained additional oversight responsibilities for Advisers with the Investment Advisers Act of 1940 (the "Advisers Act").<sup>49</sup>

Over the next several decades, Congress frequently amended the securities laws, creating a patchwork of legislation.<sup>50</sup> In the aftermath of the

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43. See HAZEN, SECURITIES REGULATION, *supra* note 32, § 1.6. Although the Securities Act of 1933 and the Exchange Act of 1934 define the term "security" in slightly different ways, the Supreme Court has interpreted the statutes' definitions as "virtually identical." *Tcherepnin v. Knight*, 389 U.S. 332, 335 (1967).

44. *SEC v. W.J. Howey Co.*, 328 U.S. 293, 298–99 (1946).

45. See, e.g., *Smith v. Gross*, 604 F.2d 639 (9th Cir. 1979).

46. 15 U.S.C. § 77c(a)(8) (2012).

47. See HAZEN, SECURITIES REGULATION, *supra* note 32, § 1.2[3][B].

48. See 15 U.S.C. § 78o-3 (2012).

49. See 15 U.S.C. § 80b-1 (2012).

50. See JOHN C. COFFEE, JR. & HILLARY A. SALE, SECURITIES REGULATION 57 (11th ed. 2009) ("The 1934 Act has been frequently amended; indeed, it has become the Christmas

2008 financial crisis, it adopted Dodd-Frank to “protect consumers from abusive financial services practices.”<sup>51</sup> Dodd-Frank is the most extensive financial regulation ever adopted by Congress, and it dedicates Title IX to investor protection and securities regulation.<sup>52</sup> Among other things, Dodd-Frank created the Office of the Investor Advocate and directed the Commission to review and report on the standards of care for broker-dealers and Advisers giving advice to retail customers.<sup>53</sup> It also authorized—but did not require—the Commission to harmonize these standards of care by imposing a fiduciary duty on broker-dealers.<sup>54</sup>

## 2. State Law Protections

Buttressing these overarching federal protections, states were also able to continue to regulate the securities markets through the enactment of blue sky laws.<sup>55</sup> Like the federal securities laws, state blue sky laws regulate the issuance of securities, secondary market trading, and the activities of broker-dealers and Advisers.<sup>56</sup> Unlike the federal securities laws, states securities acts often allow state regulators to analyze the merits of the investment before certain securities can be offered for sale within that state’s borders.<sup>57</sup> Although some federal securities laws preempt state securities laws, expressly allowing for concurrent state regulation is the norm.<sup>58</sup> States retain significant authority over broker-dealer activities, regulating their registration and enforcing anti-fraud provisions to police their behavior.<sup>59</sup> The federal securities laws also reserve regulation of smaller Advisers to the states.<sup>60</sup> In addition to explicit state statutory and regulatory requirements, state common law also regulates securities professionals. While the law varies significantly from state-to-state, some states, like California, impose a fiduciary duty on Brokers operating within their jurisdiction.<sup>61</sup> As discussed below, this standard may exceed stan-

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tree on which Congress almost annually hangs a new ornament in the form of new amendments.”).

51. Dodd-Frank Act, Pub. L. No. 111-203, 124 Stat. 1376, 1376 (2010).

52. HAZEN, *SECURITIES REGULATION*, *supra* note 32, § 1.2[3][D][4] (“The Dodd-Frank Act which spans six hundred pages is the most comprehensive financial regulation every adopted by Congress, as measured by the number of subject, activities, and financial institutions that are covered by the Act.”).

53. *Id.*

54. *Id.*

55. *Id.* § 8.1[1][A] (“[E]mphasis on federal law should not be taken to indicate, however, that the states do not play a significant role in regulating securities transactions.”).

56. *Id.*

57. *Id.* § 8.1[1][B], at 423.

58. *Id.* at 830–32.

59. *Id.*

60. *Id.*

61. See *Twomey v. Mitchum, Jones & Templeton, Inc.*, 262 Cal. App. 2d 690, 708 (1968); *Hobbs v. Eichler*, 164 Cal. App. 3d 174, 201 (1985) (“The relevant law is clear. ‘The relationship between a broker and principal is fiduciary in nature and imposes on the broker

dards imposed by federal law. While the federal law definition of a security controls the reach of the federal securities laws, states will sometimes apply their own definition of the term in interpreting their own laws.<sup>62</sup>

### B. Insurance Regulation, an Overview

In contrast to the dual state and federal regulation of the securities industry, insurance has long been regulated by the states. In 1851, New Hampshire appointed the first state insurance commissioner.<sup>63</sup> Other states followed suit and within 20 years, every state had an insurance regulator.<sup>64</sup> In contrast, federal law has had limited application to insurance. In 1868, the Supreme Court considered whether insurance regulation fell within the federal government's purview.<sup>65</sup> In *Paul v. Virginia*, the Court held that "[i]ssuing a policy of insurance is not a transaction of commerce . . . . They are not subjects of trade and barter offered in the market as something having an existence and value independent of the parties to them . . . . They are like other personal contracts between parties which are completed by the signature and the transfer of the consideration."<sup>66</sup> The Court considered the contracts as local transactions, and as such, "the Federal government can no more regulate the commerce of a State than a State can regulate the commerce of the Federal government."<sup>67</sup> This decision found that insurance contracts fell outside the early Commerce Clause interpretation and were left to state regulation.

#### 1. Attempts at Federal Regulation of Insurance

Notwithstanding the Court's view that insurance was a local transaction, calls for federal regulation of the insurance industry increased in the early 20th century. In 1904, President Theodore Roosevelt spoke in favor

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the duty of acting in the highest good faith toward the principal.'"); *E.F. Hutton & Co. v. Weeks*, 304 S.E.2d 420, 422 (Ga. Ct. App. 1983) ("The broker's duty to account to its customer is fiduciary in nature, resulting in an obligation to exercise the utmost good faith."); *Roth v. Roth*, 571 S.W.2d 659, 668 (Mo. Ct. App. 1978).

62. For example, some states and federal courts have applied the "risk capital" test to identify securities under state law. *See Silver Hills Country Club v. Sobieski*, 55 Cal. 2d 811 (1961). Most articulations of the test involve three elements: (1) the investment of money; (2) in the risk capital of a scheme or enterprise; and (3) the expectation of a valuable benefit. 12 JOSEPH C. LONG, *BLUE SKY LAW* § 2:80 (2014). Conversely, Hawaii applies a different articulation of the risk capital test which requires that the investor has no right to participate in managing the common enterprise. *See State v. Hawaii Mkt. Ctr.*, 52 Haw. 642, 485 P.2d 105 (1971).

63. *See* FED. INS. OFFICE, *HOW TO MODERNIZE AND IMPROVE THE SYSTEM OF INSURANCE REGULATION IN THE UNITED STATES* 11 (2013) [hereinafter *FIO REPORT*].

64. In 1871, there were 36 states, and each one had an insurance regulator. *See id.*

65. *See Paul v. Virginia*, 75 U.S. 168 (1868).

66. *Id.* at 183.

67. *Id.* at 183–84.

of federal regulation of insurance.<sup>68</sup> Contrary to the view of the Court, President Roosevelt described the insurance industry as “national and not local in its application” and explained that it “involves a multitude of transactions among the people of the different States and between American companies and foreign governments.”<sup>69</sup> In 1905, President Roosevelt made a more urgent plea for federal regulation of the insurance industry:

There is need of a far stricter and more uniform regulation of the vast insurance interests of this country. The United States should in this respect follow the policy of other nations by providing adequate national supervision of commercial interests which are clearly national in character . . . . That State supervision has proved inadequate is generally conceded. The burden upon insurance companies, and therefore their policy holders, of conflicting state regulations of many States, is unquestioned, while but little effective check is imposed upon any able and unscrupulous man who desires to exploit the company in his own interest at the expense of the policy holders and of the public. The inability of a State to regulate effectively insurance corporations created under the laws of other States and transacting the larger part of their business elsewhere is also clear. As a remedy for this evil of conflicting, ineffective, and yet burdensome regulations there has been for many years a widespread demand for Federal supervision.<sup>70</sup>

Shortly thereafter, Senator John Dryden of New Jersey introduced a bill in the Senate to establish a Bureau of Insurance in the Department of Commerce and Labor.<sup>71</sup> This was one of several bills introduced between 1902 and 1906 providing for federal regulation of the insurance industry.<sup>72</sup> None of the bills were passed, and the judiciary committees of both the House of Representatives and the Senate concluded that the regulation of insurance was beyond the power of Congress.<sup>73</sup> Throughout the early 20th century, Congress repeatedly demonstrated its intent to avoid interfering with state regulation of the insurance industry. Federal bankruptcy laws exempted insurance corporations from those who may become bankrupt.<sup>74</sup> In 1933, when Congress passed the Securities Act, it explicitly ex-

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68. FIO REPORT, *supra* note 63, at 13; *see also* *United States v. S.-E. Underwriters Ass’n*, 322 U.S. 533, 592 n.13 (1944) (Jackson, J., dissenting).

69. FIO REPORT, *supra* note 63, at 13.

70. President Theodore Roosevelt, President’s Annual Message, 40 CONG. REC. 90, 95 (Dec. 5, 1905) (read by Charles G. Bennett, Sec’y of the United States Senate).

71. *See* FIO REPORT, *supra* note 63, at 13; *see also* *S.-E. Underwriters Ass’n*, 322 U.S. at 593 n.15 (Jackson, J., dissenting).

72. *See, e.g.*, H.R. 7054, 58th Cong. (2d Sess. 1903); H.R. 13791, 58th Cong. (2d Sess. 1904); H.R. 16274, 58th Cong. (3d Sess. 1904); S. 7277, 58th Cong. (3d Sess. 1905); H.R. 15092, 59th Cong. (1st Sess. 1906); H.R. Res. 417, 59th Cong. (1st Sess. 1906); *see also* *S.-E. Underwriters Ass’n*, 322 U.S. at 576 n.8 (Stone, J., dissenting).

73. *See* *S.-E. Underwriters Ass’n*, 322 U.S. at 576 (Stone, J., dissenting) (noting that the House Committee specifically recognized the Supreme Court’s holding that insurance is not commerce).

74. *See* 11 U.S.C. § 22 (1940) (deeming insurance corporations ineligible for voluntary or involuntary bankruptcy); *see also* *S.-E. Underwriters Ass’n*, 322 U.S. at 593 n.15 (Jackson, J., dissenting).

cluded insurance companies under state supervision from the Act's scope.<sup>75</sup> Congress once again exempted insurance companies supervised by state authority from regulation as investment companies in 1940 when it enacted the Investment Company Act of 1940.<sup>76</sup>

As the insurance industry grew, its relationship to the national economy also grew. In 1944, the Supreme Court recognized this change in *United States v. South-Eastern Underwriters Association*, finding that the insurance industry had a significant impact on interstate commerce and echoed the tone struck by President Roosevelt 40 years earlier:

The modern insurance business holds a commanding position in the trade and commerce of our Nation. Built upon the sale of contracts of indemnity, it has become one of the largest and most important branches of commerce. Its total assets exceed \$37,000,000,000, or the approximate equivalent of the value of all farm lands and buildings in the United States. Its annual premium receipts exceed \$6,000,000,000, more than the average annual revenue receipts of the United States Government during the last decade. Included in the labor force of insurance are 524,000 experienced workers, almost as many as seek their livings in coal mining or automobile manufacturing. Perhaps no modern commercial enterprise directly affects so many persons in all walks of life as does the insurance business. Insurance touches the home, the family, and the occupation or the business of almost every person in the United States.<sup>77</sup>

In *South-Eastern*, the Court reconsidered the same issue that it had considered 76 years earlier in *Paul v. Virginia*: whether insurance fell within the Commerce Clause.<sup>78</sup> It concluded that Congress did have the authority to regulate insurance, holding that, “[n]o commercial enterprise of any kind which conducts its activities across state lines has been held to be wholly beyond the regulatory power of Congress under the Commerce Clause. We cannot make an exception of the business of insurance.”<sup>79</sup>

However, the decision did not lead to or directly involve federal regulation of the insurance industry. The Court considered the issue in the context of an antitrust claim and whether the antitrust laws extended to the insurance industry—which had previously been exempted from interstate commerce. The United States had indicted the South-Eastern Underwriters Association and others in the District Court for alleged violations of the Sherman Anti-Trust Act.<sup>80</sup> The Court held that the Sherman Act did apply to the insurance industry, although nowhere in the statute did it explicitly state that it applied to insurance.<sup>81</sup>

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75. See 15 U.S.C. § 77c(a)(8) (1934); see also *S.-E. Underwriters Ass'n*, 322 U.S. at 593 n.15 (Jackson, J., dissenting).

76. See 15 U.S.C. §§ 80a-2(a)(17), 80a-3(c)(3) (1940); see also *S.-E. Underwriters Ass'n*, 322 U.S. at 593 n.15 (Jackson, J., dissenting).

77. *S.-E. Underwriters Ass'n*, 322 U.S. at 539–40.

78. See *Id.* at 533.

79. *Id.* at 553.

80. *Id.* at 534.

81. See *Id.* at 553–62 (explaining the Court's reasoning for its holding).

Despite the recognition of federal authority over insurance, the industry remained largely a state regulatory concern. Shortly after *South-Eastern*, Congress acted quickly to ensure that the states retained regulatory control over the insurance industry.<sup>82</sup> Congress passed the McCarran-Ferguson Act,<sup>83</sup> which provides in relevant part that “[n]o Act of Congress shall be construed to invalidate, impair, or supersede any law enacted by any State for the purpose of regulating the business of insurance . . . unless such Act specifically relates to the business of insurance.”<sup>84</sup>

After the passage of the McCarran-Ferguson Act, there were a number of renewed attempts at federal regulation of the insurance industry. Following waves of insurer insolvencies in the 1960s and again in the 1980s and 1990s, bills were introduced calling for federal regulation.<sup>85</sup> However, again, the bills were not passed and insurance regulation remained wholly with the states. In 1999, Congress passed the Gramm-Leach-Bliley Act (“GLBA”), which was meant to “provid[e] a prudential framework for the affiliation of banks, securities firms, insurance companies, and other financial service providers . . . .”<sup>86</sup> While GLBA permitted the creation of financial holding companies, which contained insurance subsidiaries, GLBA preserved the states’ authority to regulate the insurance subsidiary.<sup>87</sup> Congress remained reluctant to interfere with the states’ autonomous regulation of the insurance industry.

A slight change occurred after the 2008 financial crisis. In 2010, subtitle A of Title V of Dodd-Frank,<sup>88</sup> entitled the Federal Insurance Office Act, established the Federal Insurance Office (the “FIO”) in the U.S. Department of the Treasury.<sup>89</sup> Dodd-Frank has granted the FIO limited authority to monitor the insurance industry, conduct studies, and make recommendations.<sup>90</sup> Currently, the FIO does not have any real regulatory authority over the insurance industry and it has not yet called for comprehensive federal oversight. In December 2013, the FIO issued a report, pursuant to one of its mandates under Dodd-Frank, entitled “How to Modernize and Improve the System of Insurance Regulation in the United States,” which recognizes the inefficiencies and lack of uniformity inherent in a state-based regulatory structure.<sup>91</sup> However, the report does not view the solution to the problem as one in which federal regulation displaces

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82. See FIO REPORT, *supra* note 63, at 15; see also SEC v. Nat’l Sec., Inc., 393 U.S. 453, 458 (1969).

83. McCarran-Ferguson Act, 15 U.S.C. §§ 1011-1015 (2006).

84. *Id.* § 1012(b); see also FIO REPORT, *supra* note 63, at 15.

85. See FIO REPORT, *supra* note 63, at 15.

86. Gramm-Leach-Bliley Act, Pub. L. No. 106-102, 113 Stat. 1338, 1338 (1999).

87. 15 U.S.C. § 6711 (2013).

88. 31 U.S.C. § 313 (2010).

89. 31 U.S.C. §§ 313-14 (2010).

90. E.g., FIO REPORT, *supra* note 63, at 2-3.

91. *Id.* at 65.

state regulation.<sup>92</sup> The report concludes that “the debate is best reframed as one in which the question is where federal involvement is warranted, not whether federal regulation should completely displace state-based regulation.”<sup>93</sup>

Even after the financial crisis, Congress has continued to entrust regulation of the insurance industry to the states. While federal oversight has slightly increased with Dodd-Frank, Congress has not chosen to vest any federal agency with any real authority to enact rules or regulations governing the insurance activities of financial services firms. It remains to be seen whether any action will be taken following the recommendations of the FIO.

## 2. State Regulation of Insurance

While Congress stayed out of the regulation of the insurance industry, the states were quick to coordinate their efforts. In 1871, the insurance regulators of the 36 states were invited to participate in a meeting to discuss insurance regulation.<sup>94</sup> Nineteen of the states sent representatives to the inaugural meeting of the organization now known as the National Association of Insurance Commissioners (“NAIC”) to discuss the importance of uniform regulation.<sup>95</sup> The NAIC now coordinates state insurance regulation, describing itself as “the U.S. standard-setting and regulatory support organization created and governed by the chief insurance regulators from the 50 states, the District of Columbia and five U.S. territories.”<sup>96</sup> State insurance regulators are able to establish standards and best practices, conduct peer reviews, and coordinate their regulatory oversight through their participation in the NAIC.<sup>97</sup> The NAIC develops model legislation, rules, and regulations to coordinate regulatory policies among its members.<sup>98</sup>

The NAIC has established procedures for developing new state model regulations. Its formal process, known as the Procedures for Model Law Development, includes determining whether a proposed new model law or regulation involves a national standard and/or requires uniformity among all the states.<sup>99</sup> Model law development also requires a commitment of significant regulatory and NAIC resources to educate, communicate, and

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92. *See id.* at 5.

93. *Id.* at 65.

94. *Id.* at 11.

95. *Id.*

96. *About the NAIC*, NAT’L ASS’N OF INS. COMMISSIONERS (Oct. 1, 2014, 5:08 PM), [http://www.naic.org/index\\_about.htm](http://www.naic.org/index_about.htm).

97. *Id.*

98. FIO REPORT, *supra* note 63, at 12; NAT’L ASS’N OF INS. COMMISSIONERS, STATE-BASED INSURANCE REGULATION: THE SYSTEM AT WORK, Association Profile (2013) *available at* [http://www.naic.org/annual\\_report\\_2013/2013\\_annual\\_report.pdf](http://www.naic.org/annual_report_2013/2013_annual_report.pdf).

99. *See NAIC Frequently Asked Questions*, NAT’L ASS’N OF INS. COMMISSIONERS (Oct. 1, 2014, 5:30 PM), [http://www.naic.org/documents/about\\_faq.pdf](http://www.naic.org/documents/about_faq.pdf).



support the model law's implementation in the states.<sup>100</sup> Even after a model law is adopted by the NAIC, it must still be adopted by state legislatures before it becomes effective, which is not done uniformly.<sup>101</sup>

Through this process, the NAIC has developed numerous model laws and regulations on a comprehensive list of topics, including the Producer Licensing Model Act, the Annuity Disclosure Model Regulation, the Variable Life Insurance Model Regulation, the Suitability in Annuity Transactions Model Regulation, and the Life Insurance Disclosure Model Regulation.<sup>102</sup>

### III. LAWS GOVERNING PERSONALIZED FINANCIAL ADVICE

Ordinary retail customers struggle to understand the basics of modern finance, much less the complex web of interrelated state and federal laws governing the securities and insurance industries.<sup>103</sup> In general, the laws governing personal financial advice focus on the product being sold and the compensation structure of the advice giver. These legal separations can cause problems in some instances. Most notably, insurance salespersons may occasionally trespass into areas governed by the securities laws by advising a person to sell securities to buy an insurance product.<sup>104</sup> In these instances, state regulatory agencies have brought enforcement proceedings to protect investors.<sup>105</sup> Additionally, certain products, such as variable annuities, are hybrid products—both securities and insurance products. Other products, such as equity-indexed annuities, are ambiguous and may be a hybrid product or solely an insurance product depending on how they are structured and marketed to customers. Part III discusses the standards applicable to individuals selling securities and insurance products before tackling the issues that arise when products blur the line between securities and insurance products.

#### A. Law Governing Advice about Securities

Today, different standards are applicable to persons giving personalized financial advice about securities to retail customers.<sup>106</sup> Because the securities laws do not set forth an explicit standard of conduct applicable to persons giving personalized financial advice about securities, distinct standards have developed for Advisers and Brokers under the regulatory

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100. *See id.*

101. FIO REPORT, *supra* note 63, at 12.

102. *See NAIC Model Laws, Regulations and Guidelines*, NAT'L ASS'N OF INS. COMMISSIONERS (Oct. 1, 2014, 5:57 PM), [http://www.naic.org/store\\_model\\_laws.htm](http://www.naic.org/store_model_laws.htm).

103. *See generally* FIDUCIARY STUDY, *supra* note 13 (discussing, in the executive summary, the reasons that investors contact broker-dealers and investment advisers).

104. FIO REPORT, *supra* note 63, at 46.

105. *See generally* discussion *infra* at Part V.E.

106. *See generally* Barbara Black, *How to Improve Retail Investor Protection After the Dodd-Frank Wall Street Reform and Consumer Protection Act*, 13 U. PA. J. BUS. L. 59 (2010) (discussing different standards).

structures governing each.<sup>107</sup> Whether a person is considered an Adviser or a Broker is often determined by the type of compensation the person earns.<sup>108</sup> The Advisers Act applies if the advice-giver receives fee-based compensation directly related to the advice given, either hourly or as a percentage of assets.<sup>109</sup> The Exchange Act and FINRA rules apply if the advice-giver receives a sales commission for transactions instead of advice-based compensation.<sup>110</sup>

Adding to the complexity, many persons register as both Advisers and Brokers.<sup>111</sup> The duties they owe to a retail customer, then, will depend on whether they provide advice to the customer as an Adviser or as a Broker. In many instances, a single customer will have multiple accounts with the same financial adviser, who may provide advice about one account as an Adviser and advice about another account as a Broker. Finally, the differences between Advisers and Brokers are material. For one thing, Advisers operate within a less structured and more principle-based environment. Each owes different duties, receives a different form of compensation, and operates within different supervisory systems.

### 1. Personalized Financial Advice under the Advisers Act

Early regulation of investment advice was limited. Before World War I, a variety of different professionals gave advice about investing.<sup>112</sup> After the stock market crash of 1929, professionals focused on investment counseling emerged.<sup>113</sup> Only limited state regulation applied to their profession and few states even required them to register.<sup>114</sup> After a period of study, Congress enacted the Advisers Act in 1940 to regulate the profession and protect the reputation of bona fide investment advisers from the stigma that would attach if they were associated with scoundrels.<sup>115</sup>

Today, Advisers provide personalized financial advice to ordinary Americans in exchange for direct, fee-based compensation. As a starting point, the Advisers Act defines the term “investment adviser” to include:

[A]ny person who, for compensation, engages in the business of advising others, either directly or through publications or writings, as to the value of securities or as to the advisability of investing in, purchasing, or selling securi-

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107. *Id.* at 64.

108. *See* Fin. Planning Ass’n v. SEC, 482 F.3d 481, 487 (D.C. Cir. 2007).

109. *Id.*

110. *Id.*

111. FIDUCIARY STUDY, *supra* note 13, at 12 (“[A]pproximately 88% of investment adviser representatives were also registered representatives of a FINRA registered broker-dealer . . .”).

112. *See* Laby, *supra* note 13, at 717.

113. *Id.*

114. *Id.*

115. S. REP. NO. 76-1775, at 21 (1940).

ties, or who, for compensation and as part of a regular business, issues or promulgates analyses or reports concerning securities . . . .<sup>116</sup>

The Advisers Act's anti-fraud provision broadly prohibits any fraudulent practice and makes it unlawful for any Adviser: "(1) to employ any device, scheme, or artifice to defraud any client or prospective client; [or] (2) to engage in any transaction, practice, or course of business which operates as a fraud or deceit upon any client or prospective client . . . ." <sup>117</sup>

In interpreting this provision, the Supreme Court declared that it imposes "'federal fiduciary standards' to govern the conduct of investment advisers."<sup>118</sup> At the least, these fiduciary principles impose "an affirmative duty of 'utmost good faith, and full and fair disclosure of all material facts,' as well as an affirmative obligation 'to employ reasonable care to avoid misleading' . . . clients."<sup>119</sup> In *Securities and Exchange Commission v. Capital Gains Research Bureau, Inc.*, the Supreme Court found that this provision "reflects a congressional recognition 'of the delicate fiduciary nature of an investment advisory relationship,' as well as a congressional intent to eliminate, or at least to expose, all conflicts of interest which might incline as investment adviser—consciously or unconsciously—to render advice which was not disinterested."<sup>120</sup>

The Commission has expounded on Advisers' fiduciary duties and made clear that the law, by judicial interpretation, imposes continuing duties of loyalty and care.<sup>121</sup> The duty of loyalty requires Advisers to act in their clients' best interests and disclose all conflicts of interest.<sup>122</sup> The duty of care requires Advisers to provide suitable investment advice after investigating a customer's financial situation and investment objectives.<sup>123</sup> Nonetheless, the precise contours of an Adviser's duty to recommend suitable securities are less clearly defined than the standards FINRA maintains for Brokers.<sup>124</sup> No precise rule-based framework exists for evaluating the suitability of an Adviser's recommendations.

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116. 15 U.S.C. § 80b-2. Although this broad definition would seemingly encompass Brokers, the Advisers Act specifically excludes Brokers from its reach so long as: (i) their performance of investment advisory services is "solely incidental" to their business as a broker; and (ii) the Broker receives no "special compensation" for providing investment advice, e.g. a payment expressly for investment advice. 15 U.S.C. § 80b-2(a)(11)(c). For precedent on the scope of the exclusion, see *Thomas v. Metro. Life Ins. Co.*, 631 F.3d 1153, 1162 (10th Cir. 2011).

117. 15 U.S.C. § 80b-6.

118. *Transamerica Mortg. Advisors, Inc. (TAMA) v. Lewis*, 444 U.S. 11, 17 (1979) (quoting *Santa Fe Indus., Inc. v. Green*, 430 U.S. 462, 471, n. 11 (1977)).

119. *SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 194 (1963).

120. *Id.* at 191–92.

121. See FIDUCIARY STUDY, *supra* note 13, at 22.

122. *Id.*

123. *Id.* at 27–28.

124. See James S. Wrona, *The Best of Both Worlds: A Fact-Based Analysis of the Legal Obligations of Investment Advisers and Broker-Dealers and A Framework for Enhanced Investor Protection*, 68 BUS. LAW. 1, 12–13 (2012).

Advisers' fee-based compensation may come as a flat charge, an hourly rate, or, more commonly, as percentage of their clients' asset value.<sup>125</sup> Paying fees as a set percentage of assets-under-management has been praised for removing an Adviser's incentive simply to recommend products that pay greater commissions.<sup>126</sup> An asset-based fee also incentivizes Advisers to protect their clients' assets from market downturns because a reduction in their clients' asset value reduces their compensation.<sup>127</sup> Similarly, Advisers benefit from increasing their clients' asset value because their compensation rises with their clients' wealth.<sup>128</sup>

However, this compensation structure carries its own conflicts and should not be viewed as a panacea. An asset-based fee may incentivize an Adviser to take imprudent risks with their clients' assets to gain more fee revenue.<sup>129</sup> Advisers may also hesitate before recommending any transaction that reduces a client's assets-under-management—such as buying a life insurance policy or an annuity which would result in less money for Advisers to manage.<sup>130</sup>

Asset-based fees may be least appropriate for passive buy-and-hold retail customers. The Commission has expressed concern about a practice dubbed “reverse churning.”<sup>131</sup> An Adviser reverse churns an account when the Adviser collects a fee for purportedly managing an account that requires little or no management.<sup>132</sup> In practice, dual-registered Advisers may sign their former brokerage clients up for fee-based accounts for the purpose of generating revenue for their firm while not providing a corresponding benefit to their customer.<sup>133</sup> FINRA has recognized that it “is inconsistent with just and equitable principles of trade . . . to place a customer in an account with a fee structure that reasonably can be expected to result in greater cost than an alternative account offered by the member that provides the same services and benefits to the customer.”<sup>134</sup>

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125. See FIDUCIARY STUDY, *supra* note 13, at 7, 10–11.

126. See Daisy Maxey, *How to Pay Your Financial Adviser*, WALL ST. J. (Dec. 12, 2011), <http://online.wsj.com/news/articles/SB10001424052970204554204577024152103830414>.

127. *Id.*

128. *Id.*

129. *Id.*

130. *Id.*

131. Daisy Maxey, *SEC Targets ‘Reverse Churning’ by Advisers*, WALL ST. J. (Feb. 24, 2014), <http://online.wsj.com/news/articles/SB10001424052702304610404579403251590760602>.

132. See FIDUCIARY STUDY, *supra* note 13, at 152.

133. See OFFICE OF COMPLIANCE INSPECTIONS AND EXAMINATIONS, U.S. SEC. & EXCH. COMM’N, EXAMINATION PRIORITIES FOR 2014 (Jan. 9, 2014), *available at* <http://www.sec.gov/about/offices/ocie/national-examination-program-priorities-2014.pdf>.

134. NAT’L ASS’N OF SEC. DEALERS, FEE-BASED COMPENSATION, NOTICE TO MEMBERS (Nov. 2003), *available at* <http://www.finra.org/web/groups/industry/@ip/@reg/@notice/documents/notices/p003079.pdf>.

The Commission and the states share responsibility for policing Adviser behavior.<sup>135</sup> Although a number of exclusions and exceptions apply, Advisers must register with the Commission if they: (i) manage certain types of funds, such as pension funds; (ii) manage more than \$100 million in client assets; or (iii) work in a state that does not register Advisers.<sup>136</sup> Advisers not meeting these thresholds must register with the states and are prohibited from registering with the Commission.<sup>137</sup>

Advisers' supervisory and regulatory oversight also differs depending on whether they register with the Commission or with the states. Advisers registered with the Commission must comply with additional requirements and are exempted from most state regulatory requirements.<sup>138</sup> As interpreted by the Commission, the Advisers Act also regulates the manner in which Advisers may advertise their services,<sup>139</sup> requires Advisers to put in place procedures "which would reasonably be expected to prevent and detect" violations of the Advisers Act or regulations promulgated thereunder,<sup>140</sup> and mandates that Advisers keep accurate books and records.<sup>141</sup> State-registered Advisers must comply with any state-level requirements, as well as the anti-fraud provisions of the Advisers Act.<sup>142</sup>

## 2. Advice under the Exchange Act

Modern brokerage firms differ substantially from the brokerage firms of the 1930s. Then, Brokers focused primarily on the complicated process of order execution.<sup>143</sup> Without computers to speed the process, Brokers mainly delivered value by executing orders rather than giving advice about investments.<sup>144</sup> Their role has changed to focus more on giving investment advice as order execution has become increasingly automated.<sup>145</sup> Like the Advisers Act, the Exchange Act also contains an anti-fraud provision which makes it unlawful "to use or employ, in connection with the purchase or sale of any security . . . any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or

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135. See DIVISION OF INVESTMENT MANAGEMENT, U.S. SEC. & EXCH. COMM'N, REGULATION OF INVESTMENT ADVISERS BY THE U.S. SECURITIES AND EXCHANGE COMMISSION (Mar. 2013), available at [http://www.sec.gov/about/offices/oia/oia\\_investman/rplaze-042012.pdf](http://www.sec.gov/about/offices/oia/oia_investman/rplaze-042012.pdf).

136. See Advisers Act § 203, 15 U.S.C. § 80b-3 (2006 & Supp. IV 2010); Advisers Act § 203A, 15 U.S.C. § 80b-3a (2006 & Supp. IV 2010).

137. See REGULATION OF INVESTMENT ADVISERS, *supra* note 135, at 8–11.

138. *Id.* at 11.

139. See 17 C.F.R. § 275.206(4)-1 (2014).

140. Advisers Act § 203(e)(6), 15 U.S.C. § 80b-3(e)(6) (2006).

141. See 17 C.F.R. § 275.204-2(a) (2014).

142. See REGULATION OF INVESTMENT ADVISERS, *supra* note 135, at 11.

143. See Laby, *supra* note 13, at 729–30.

144. See *id.*

145. *Id.*

for the protection of investors.”<sup>146</sup> The Commission promulgated Rule 10b-5, which broadly prohibits fraud in connection with the purchase or sale of securities.<sup>147</sup> However, unlike the Advisers Act, courts have held that this section of the Exchange Act does not establish a fiduciary duty.<sup>148</sup>

A Broker’s obligations are defined by FINRA Rules, FINRA Enforcement decisions, and SEC Enforcement decisions. The SEC has delegated much of its oversight responsibility of Brokers and brokerage firms to FINRA. When giving personalized financial advice, Brokers and brokerage firms must “observe high standards of commercial honor and just and equitable principles of trade.”<sup>149</sup> More specifically, FINRA Rule 2111 (the “Suitability Rule”) governs the investment recommendations a Broker makes to a customer. The Suitability Rule provides that:

A member or an associated person must have a reasonable basis to believe that a recommended transaction or investment strategy involving a security or securities is suitable for the customer, based on the information obtained through the reasonable diligence of the member or associated person to ascertain the customer’s investment profile. A customer’s investment profile includes, but is not limited to, the customer’s age, other investments, financial situation and needs, tax status, investment objectives, investment experience, investment time horizon, liquidity needs, risk tolerance, and any other information the customer may disclose to the member or associated person in connection with such recommendation.<sup>150</sup>

Although it articulates clear duties, the Suitability Rule does not explicitly provide that a Broker’s recommendations must be in the cus-

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146. 15 U.S.C. § 78j (2012).

147. Rule 10b-5 states: “It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange, (a) To employ any device, scheme, or artifice to defraud, (b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or (c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.”

148. With respect to section 10(b) of the Exchange Act, the courts have determined that because scienter is a necessary element to find a violation of the section, the section does not confer a fiduciary duty on Brokers. As explained by the Supreme Court, “Section 10(b) makes unlawful the use or employment of ‘any manipulative or deceptive device or contrivance’ in contravention of Commission rules. The words ‘manipulative or deceptive’ used in conjunction with ‘device or contrivance’ strongly suggests that § 10(b) was intended to proscribe knowing or intentional misconduct.” *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 197, (1976).

149. *FINRA Manual*, FIN. INDUS. REGULATORY AUTH., Rule 2010, [http://finra.complinet.com/en/display/display\\_main.html?rbid=2403&element\\_id=5504](http://finra.complinet.com/en/display/display_main.html?rbid=2403&element_id=5504).

150. *FINRA Manual*, FIN. INDUS. REGULATORY AUTH., Rule 2111(b), [http://finra.complinet.com/en/display/display\\_viewall.html?rbid=2403&element\\_id=9859&print=1](http://finra.complinet.com/en/display/display_viewall.html?rbid=2403&element_id=9859&print=1). (A “member” is a broker-dealer and an “associated person” is a Broker).

tomers' best interests.<sup>151</sup> Nonetheless, FINRA Enforcement decisions and guidance materials have made clear that "a broker's recommendations must be consistent with his customers' best interests."<sup>152</sup>

Absent special circumstances, these specific obligations only attach if and when the Broker gives investment advice.<sup>153</sup> In some cases, a continuing duty to monitor a customer's account may arise if the Broker gains discretionary control over the account or state common law imposes a fiduciary duty.<sup>154</sup> For customers, this means that the Broker owes them duties when making a recommendation, but does not generally have any duty to continue to oversee their accounts. Brokers giving personalized financial advice under the Exchange Act do so in exchange for sales commissions in connection with a transaction.<sup>155</sup> Absent some transaction, a Broker does not receive any compensation. However, the compensation received is incidental to the advice given; otherwise, the Broker would be considered an Adviser under the Advisers Act.<sup>156</sup>

Even though the law requires Brokers to only recommend suitable products, financial incentives produced by commission-based compensation may distort Brokers' advice. Notably, the amount of a Broker's compensation may vary depending on the product she buys or sells for the customer. This compensation structure has caused many to worry that Brokers may not provide objective advice.<sup>157</sup> For instance, when deciding between two similar and suitable products, Brokers have a financial incentive to recommend the higher-commission product. In 1995, the Commission released the Report of the Committee on Compensation Practices, which recognized that paying Brokers more money for selling one product over another raised questions as to whether a Broker rendered "objective advice or simply maximize[ed] commission income."<sup>158</sup> FINRA echoed these concerns in 2013 when it released a report on conflicts of interest,

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151. Lazaro, *supra* note 16, at 132 ("[T]he suitability standard requires that a recommendation merely be suitable for a customer, not necessarily that it be in the customer's best interest . . .").

152. See Wrona, *supra* note 124, at 19 (collecting sources).

153. For a discussion of circumstances where Brokers may owe ongoing fiduciary duties, see Benjamin P. Edwards, *Fiduciary Duty & Investment Advice: Will an Uniform Fiduciary Duty Make a Material Difference?*, J. BUS. & SEC. L. (forthcoming).

154. *Id.*

155. See Wrona, *supra* note 124, at 5–6 (discussing fee structures).

156. Brokers and dealers are not subject to the requirements of the Advisers Act where their investment advice is (1) "solely incidental to the conduct of [their] business as a broker or dealer," and (2) the broker or dealer "receives no special compensation therefor." 15 U.S.C. § 80b–2(a)(11)(C) (2000). *Fin. Planning Ass'n v. S.E.C.*, 482 F.3d 481, 483 (D.C. Cir. 2007).

157. See Donald C. Langevoort, *Brokers As Fiduciaries*, 71 U. Pitt. L. Rev. 439, 448 (2009) (questioning the wisdom of differential commissions).

158. COMMITTEE ON COMPENSATION PRACTICES, U.S. SEC. & EXCH. COMM'N, REPORT OF THE COMMITTEE ON COMPENSATION PRACTICES 8 (1995), available at <http://www.sec.gov/news/studies/bkrcomp.txt>.



praising broker-dealer efforts to mitigate the financial incentive to recommend one product over another.<sup>159</sup>

To manage these conflicts of interest, FINRA requires brokerage firms to closely supervise Brokers to ensure that customers receive suitable recommendations.<sup>160</sup> In particular, FINRA requires broker-dealers to create a supervisory hierarchy and certify that they have put in place “processes to establish, maintain, review, test and modify written compliance policies and written supervisory procedures reasonably designed to achieve compliance with applicable FINRA rules, MSRB rules and federal securities laws and regulations . . . .”<sup>161</sup> Numerous specific requirements exist to ensure that brokerage firms satisfy their supervisory obligations. FINRA requires that Brokers pass licensing examinations to demonstrate their competence and receive continuing education about “compliance, regulatory, ethical and sales-practice standards.”<sup>162</sup> To ensure that recommendations fit a customer’s needs, FINRA’s “Know Your Customer” rule requires that Brokers and brokerage firms “use reasonable diligence, in regard to the opening and maintenance of every account, to know (and retain) the essential facts concerning every customer.”<sup>163</sup> FINRA claims that effective supervision within this system “is the foundation of ensuring investor protection and market integrity.”<sup>164</sup>

#### B. Rules Applicable to Personalized Financial Advice about Insurance

In the insurance context, retail customers receive personalized financial advice from state insurance agents, also known as “Producers.”<sup>165</sup> These Producers often serve as a retail customer’s most significant contact with the insurance industry. Because insurance is regulated at the state-level, insurance regulation varies substantially state-by-state, making it difficult to describe a Producer’s duties to a customer with precision.<sup>166</sup> When a Producer sells an insurance product, state insurance departments determine what duties apply based on the statutes in place. These duties also vary depending on the insurance product being sold to the customer.

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159. FIN. INDUS. REGULATORY AUTH., REPORT ON CONFLICTS OF INTEREST 26–30 (Oct. 2013), available at <http://www.finra.org/web/groups/industry/@ip/@reg/@guide/documents/industry/p359971.pdf>.

160. See Wrona, *supra* note 124, at 37.

161. *FINRA Manual*, FIN. INDUS. REGULATORY AUTH., Rule 3130(b), [http://finra.complinet.com/en/display/display\\_main.html?rbid=2403&element\\_id=6286](http://finra.complinet.com/en/display/display_main.html?rbid=2403&element_id=6286).

162. FIDUCIARY STUDY, *supra* note 13, at 77.

163. *FINRA Manual*, FIN. INDUS. REGULATORY AUTH., Rule 2090, [http://finra.complinet.com/en/display/display\\_main.html?rbid=2403&element\\_id=9858](http://finra.complinet.com/en/display/display_main.html?rbid=2403&element_id=9858).

164. *Id.* 3130.03.

165. For this Article, a Producer is defined as an insurance “agent or broker who markets, distributes or sells an insurance product to a consumer.” FIO REPORT, *supra* note 63, at 46.

166. *Id.*

For the purposes of this Article, Part III primarily focuses on the Producer's duties when selling annuities.

In 2000, the NAIC adopted a white paper recommending the establishment of suitability standards for life insurance and annuities.<sup>167</sup> At the time, six states had broad suitability standards for annuity products.<sup>168</sup> These states prohibited Producers from recommending a product with reasonable grounds to believe the product was unsuitable for the customer.<sup>169</sup> Some states provided guidance on how to determine suitability, basing it on an inquiry into criteria such as the customer's objectives, financial situation, and needs.<sup>170</sup> Yet most states lacked suitability requirements.<sup>171</sup> After adopting the white paper, the NAIC also appointed a working group to draft a model act and regulation.<sup>172</sup> The wide-reaching standard in the original formulation, however, was met with little support.<sup>173</sup> The working group then redrafted the model regulation to impose a more limited standard and to apply only to the sale of annuities to seniors, resulting in the "Senior Protection in Annuity Transactions Model Regulation."<sup>174</sup> In 2006, the NAIC expanded the scope of the model regulation to apply to all annuity transactions, and it was renamed the Suitability in Annuity Transactions Model Regulation (the "Model Regulation").<sup>175</sup>

The Model Regulation is similar to the FINRA suitability standard. It requires that the Broker or Producer have "reasonable grounds for believing that the recommendation is suitable for the consumer on the basis of the facts disclosed by the consumer as to his or her investments and other insurance products and as to his or her financial situation and needs, including the consumer's suitability information."<sup>176</sup> In addition, the Broker or Producer must have a reasonable basis for believing that the consumer has received specific information about the annuity, and that particular aspects of the annuity are suitable for the consumer.<sup>177</sup> The Model Regulation defines "suitability information" to include the following: (1) age; (2) annual income; (3) financial situation and needs, including

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167. NAT'L ASS'N OF INS. COMM'RS, *SUITABILITY OF SALES OF LIFE INSURANCE AND ANNUITIES*, (June 2000) [hereinafter NAIC WHITE PAPER], available at <http://www.naic.org/store/free/SOS-LI.pdf>. See also, NAT'L ASS'N OF INS. COMM'RS, *SUITABILITY IN ANNUITY TRANSACTIONS MODEL REGULATION*, LH-275-1 (April 2010), [hereinafter NAIC MODEL REGULATION] available at <http://www.naic.org/store/free/MDL-275.pdf>.

168. See e.g., IOWA ADMIN. CODE r. 191-15.8 (2011); KAN. ADMIN. REGS. § 40-2-14(c)(5) (2014); MINN. STAT. § 60K.14 (2011); MINN. STAT. § 72A.20 (2014); WIS. ADMIN. CODE INS. § 2.16(6) (2014). NAIC WHITE PAPER, *supra* note 167, at 10–14.

169. NAIC WHITE PAPER, *supra* note 167, at 11–14.

170. *Id.*

171. NAIC MODEL REGULATION, *supra* note 167, at LH-275-1.

172. *Id.*

173. *Id.*

174. *Id.*

175. *Id.*

176. NAIC MODEL REGULATION, *supra* note 167, § 6.A.

177. *Id.* § 6.A(1)–(4).

the financial resources used for the funding of the annuity; (4) financial experience; (5) financial objectives; (6) intended use of the annuity; (7) financial time horizon; (8) existing assets, including investment and life insurance holdings; (9) liquidity needs; (10) liquid net worth; (11) risk tolerance; and (12) tax status.<sup>178</sup>

There is substantial variation in the adoption of the Model Regulation. Some states have adopted the duties found in the Model Regulation.<sup>179</sup> Several states have adopted the duties found in a prior version of the Model Regulation, which define the information that must be considered in determining the suitability of the transaction less specifically and require less disclosure about the annuity.<sup>180</sup> One state adopted the original version of the Model Regulation as it applied only to senior consumers,<sup>181</sup> and other states have adopted some variation of a suitability standard.<sup>182</sup> Only New Mexico has not adopted any suitability standards to govern annuity sales.<sup>183</sup>

States generally require Producers to be licensed and to register. Even though states share information with each other, each state independently licenses the Producers operating within its territory.<sup>184</sup> In 2013, the National Insurance Producer Registry (“NIPR”), a non-profit associated with

178. *Id.* § 5.I

179. ALASKA ADMIN. CODE tit. 3, § 26.775 (2011); CAL. INS. CODE § 10509.914 (West 2011); COLO. CODE REGS. § 702-4:4-1-11 (2011); CONN. AGENCIES REGS. § 38a-432a-5 (2012); D.C. MUN. REGS. tit. 26-A, § 8403 (2010); FLA. STAT. ANN. § 627.4554 (West 2013); 2012-9 Haw. Rev. Stat. Ann. Adv. Legis. Serv. 608-610 (LexisNexis); IDAHO ADMIN. CODE r. 18.01.09.015 (2013); ILL. ADMIN. CODE tit. 50, § 3120.50 (2011); IOWA ADMIN. CODE r. 191-15.75(507B) (2012); KAN. ADMIN. REGS. § 40-1-14a (2013); 806 KY. ADMIN. REGS. 12:120 (2012); MD. CODE REGS. 31.09.12.04 (2014); MICH. COMP. LAWS ANN. § 500.4155 (West 2013); MINN. STAT. ANN. § 72A.2032 (West 2013); 19-2 MISS. CODE R. § 18.06 (West 2013); NEB. REV. STAT. § 44-8106 (2012); N.J. ADMIN. CODE § 11:4-59A.3 (2013); N.Y. COMP. CODES R. & REGS. tit. 11, § 224.4 (2013); N.D. CENT. CODE § 26.1-34.2-03 (2011); OHIO ADMIN. CODE 3901-6-13 (2011); OR. ADMIN. R. 836-080-0180 (2011); 11-5 R.I. CODE R. § 12:6; S.C. CODE ANN. REGS. 69-29 (2011); S.D. CODIFIED LAWS § 58-33A-16 (2012); TEX. INS. CODE ANN. art. 1115.051 (West 2011); UTAH ADMIN. CODE r. 590-230 (2012); WASH. ADMIN. CODE § 284-23-390 (2012); W. VA. CODE R. § 114-11B-5 (2011); WIS. STAT. ANN. § 628-347 (West 2012).

180. ALA. ADMIN. CODE r. 482-1-137-.06 (2006); 054-00-082 ARK. CODE R. § 6 (LexisNexis 2009); ARIZ. REV. STAT. § 20-1243.03 (LexisNexis 2014); GA. COMP. R. & REGS. 120-2-94.06 (2006); 760 IND. ADMIN. CODE 1-72-4 (2009); LA. ADMIN. CODE tit. 37, § 11711 (2014); 211 MASS. CODE REGS. 96.06 (2014); 02-031-917 ME. CODE R. § 6 (2007); MONT. CODE ANN. §33-20-805 (2007); N.C. GEN. STAT. § 58-60-170 (2009); N.H. CODE ADMIN. R. ANN. INS. 305.05 (2009); OKLA. ADMIN. CODE § 365:25-17-7 (2006); 40 PA. CONS. STAT. ANN. § 627-3 (2010); TENN. COMP. R. & REGS. 0780-01-86-.06 (2008); 14 VA. ADMIN. CODE § 5-45-40 (2007).

181. 18 DEL. ADMIN. CODE § 1214-6.0 (2014).

182. VT. STAT. ANN. tit. 8, §4724(16) (2007); MO. CODE REGS. ANN. tit. 20, § 700-1.146 (2007); NEV. ADMIN. CODE § 688A.455 (2006); 44-27 WYO. CODE R. § 11 (LexisNexis 1996).

183. The NAIC tracks adoption of the Model Regulation, and its information indicates that New Mexico has not adopted the Model Regulation. NAIC MODEL REGULATION, *supra* note 167, at LH-275-6.

184. NAIC WHITE PAPER, *supra* note 167, at 2.

the NAIC, included registration information for 2.3 million individuals holding more than six million state-issued licenses.<sup>185</sup> Like Brokers, Producers are generally paid a commission for selling annuities. However, the commission is usually paid by the insurance company issuing the annuity as part of the company's overall expenses and is built into the annuity's expenses.<sup>186</sup>

#### IV. FINANCIAL INNOVATION CHALLENGES THE STOVEPIPE REGULATORY STRUCTURES

Financial and technological innovation has radically changed the world of investing. While the roles of Brokers, Advisers, and Producers have changed, so too have the products they sell. To show the need for more uniform standards for persons giving personalized financial advice across the securities and insurance industries, we spotlight the issues created by just one novel product—equity-indexed annuities. Increasingly complex financial products like equity-indexed annuities demonstrate the need for more coherent regulation.

##### A. *From Ancient to Modern Annuities*

Annuities have a long history: during the Roman Empire, Roman citizens would have contracts known as *annua* to which they would make a one-time payment in exchange for income payments received once a year for the rest of their lives.<sup>187</sup> Today, an annuity is defined as a contract between a person and an insurance company to protect against the risk of outliving savings.<sup>188</sup> In exchange for a payment or series of payments, the insurance company agrees to make periodic payments to the person on whose life the contract is based, known as the annuitant, beginning immediately or at some point in the future for a set number of years or until the annuitant dies.<sup>189</sup>

Over time, annuities have grown more complex. Importantly, not all annuities begin to pay the annuitant immediately. When payments to the annuitant start immediately, the product is known as an immediate annu-

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185. See NAT'L INS. PRODUCER REGISTRY, ANNUAL REPORT 9 (2013), available at <http://www.nipr.com/docs/annual-reports/2013-nipr-annual-report.pdf>.

186. See *Facts About Annuities – Edition 1*, NAT'L ASS'N FOR FIXED ANNUITIES, <http://fixedannuityfacts.com/tips> (last visited Nov. 16, 2014); see also *Variable Annuities: What You Should Know*, U.S. SEC. & EXCH. COMM'N, <http://www.sec.gov/investor/pubs/varannty.htm> (last visited Nov. 16, 2014) ("Profit from the mortality and expense risk charge is sometimes used to pay the insurer's costs of selling the variable annuity, such as a commission paid to [the] financial professional for selling the variable annuity to [the customer].").

187. IRI FACTBOOK, *supra* note 22, at 27.

188. *Annuities*, U.S. SEC. & EXCH. COMM'N, <http://www.sec.gov/answers/annuity.htm> (last visited Nov. 16, 2014) [hereinafter *SEC Annuities*].

189. *Id.*

ity.<sup>190</sup> When income payments will begin at some future point, the product is known as a deferred annuity.<sup>191</sup> Deferred annuity contracts have two phases, the first being an accumulation or savings phase, and the second being a payout or income phase.<sup>192</sup> Deferred annuity contracts offer retail customers a way to accumulate savings on a tax-deferred basis.<sup>193</sup> For annuities purchased with after-tax funds, this means that interest, dividends, and capital gains will not be taxed until the funds are withdrawn from the annuity contract.<sup>194</sup> The value of this benefit increases with time because money not paid out in taxes may earn more interest within the annuity contract.

During the savings phase, the funds within a deferred annuity contract may change in value. For a fixed annuity, the insurance company guarantees at least a certain minimum rate of investment return.<sup>195</sup> The insurance company also commits to pay a certain amount per dollar value of the account per year if the contract holder elects to annuitize, or in other words move into the payout phase and begin receiving periodic payments.<sup>196</sup> Fixed annuities are regulated solely at the state-level and are explicitly exempted from registration under the Securities Act.<sup>197</sup>

With a variable annuity, the funds in the contract change value differently. After placing funds within a variable annuity contract, the retail customer is offered a variety of different options in which to invest her premium payments. The amount accumulated depends on the performance of the investment options. The retail customer may make or lose money depending on the performance of the investment options chosen. Accordingly, the contract value and the income payments are not guaranteed—they are variable.<sup>198</sup>

The federal securities laws apply to variable annuities. As a variable annuity's assets are ultimately invested in securities and exposed to risk, the offer and sale of variable annuities fall squarely within the jurisdiction

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190. FIN. INDUS. REGULATORY AUTH., VARIABLE ANNUITIES: BEYOND THE HARD SELL 1 (2012), available at <http://www.finra.org/web/groups/investors/@inv/documents/investors/p125846.pdf>.

191. *Id.*

192. IRI FACTBOOK, *supra* note 22, at 29.

193. *Id.* Deferring taxes until a later date allows an investor to make substantial additional returns.

194. IRI FACTBOOK, *supra* note 22, at 77.

195. *SEC Annuities*, *supra* note 188.

196. *Id.*

197. See 15 U.S.C. § 77c(a)(8) (2012) (exempting annuity and optional annuity contracts from the 1933 Act when subject to state insurance laws).

198. Some variable annuities offer “riders” which provide guarantees as to minimum contract values and income payments. These riders are offered for a fee and guarantee that the customer will receive a minimum amount back regardless of the performance of the investment options chosen for the premium payments. See *SEC Annuities*, *supra* note 188.

of the Commission and FINRA.<sup>199</sup> As hybrid insurance products, state insurance regulators also enjoy jurisdiction over variable annuity products.<sup>200</sup>

### B. *Equity-Indexed Annuities*

Insurance companies quietly introduced a new breed of annuity, the equity-indexed annuity, in the mid-1990s.<sup>201</sup> These products credit contract owners with returns based on the performance of some index, such as the S&P 500 or the Dow Jones Industrial Average. Because the products were most often tied to equity market indexes, they were first known as equity-indexed annuities.<sup>202</sup> The products share characteristics with both fixed and variable annuities.<sup>203</sup> Like a fixed annuity, equity-indexed annuities may offer a minimum guaranteed interest rate and, under state insurance law, the insurance company will guarantee the equity-indexed annuity's contract value up to the principal amount.<sup>204</sup> Like a variable annuity, the rate of return for an equity-indexed annuity will vary based on the performance of a securities index, such as the S&P 500 or the Dow Jones Industrial Average.<sup>205</sup>

Unlike variable annuities, however, equity-indexed annuities typically do not diminish in value if a market index declines in value over a set period.<sup>206</sup> If the relevant index goes down during the relevant time period, no deduction is taken from the value of the annuity.<sup>207</sup> In exchange for this downside protection, some equity-indexed annuities cap the amount that may be earned when the index's value goes up. For example, if an index increased 6% in a year, the equity-indexed annuity might only permit a maximum rate of return of 5%.<sup>208</sup> Forecasting anticipated returns may be difficult because the insurance companies selling equity-in-

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199. See *SEC v. Variable Annuity Life Ins. Co. of Am.*, 359 U.S. 65 (1959) ("VALIC"); see also *SEC v. United Benefit Life Ins. Co.*, 387 U.S. 202, 204 (1967).

200. See *Variable Annuities*, NAT'L ASS'N OF INS. COMMISSIONERS (Oct. 27, 2014), available at [http://www.naic.org/cipr\\_topics/topic\\_variable\\_annuities.htm](http://www.naic.org/cipr_topics/topic_variable_annuities.htm).

201. Indexed Annuities and Certain Other Insurance Contracts, *supra* note 21, at 8.

202. The products are also known and currently branded as "fixed-indexed annuities." This Article refers to them as equity-indexed annuities because the Commission and FINRA both refer to them as equity-indexed annuities and because their returns are generally derived from an equity index, not a fixed index.

203. FIN. INDUS. REGULATORY AUTH., *EQUITY-INDEXED ANNUITIES: A COMPLEX CHOICE 2* (2012), available at <http://www.finra.org/web/groups/investors/@inv/@protect/@ia/documents/investors/p125847.pdf>.

204. See *Am. Equity Inv. Life Ins. Co. v. SEC*, 613 F.3d 166, 168 (D.C. Cir. 2010).

205. *Id.* at 169.

206. *SEC Annuities*, *supra* note 188, at 13.

207. *Id.*

208. *Id.*

dexed annuities generally reserve the right to alter the formulas by which the investor's gains will be calculated.<sup>209</sup>

Like most deferred annuities, equity-indexed annuities typically do not charge retail investors any up-front fee on the purchase date.<sup>210</sup> This does not mean, however, that an investor cannot lose money with an equity-indexed annuity. Most contracts include "surrender fees," which must be paid if the annuity contract owner decides to cancel the contract before a certain amount of time has passed.<sup>211</sup> Many surrender fee provisions begin in a range of 5% to 7% and gradually diminish the longer the investor holds the equity-indexed annuity.<sup>212</sup> However, some deferred annuities charge surrender fees of up to 25% for early termination.<sup>213</sup>

### C. The Regulatory Controversy

Equity-indexed annuities have been regulated by both insurance and securities regulators.<sup>214</sup> While the regulatory history of variable dates back to the 1950s,<sup>215</sup> insurance companies for the most part have quietly sold equity-indexed annuities since their introduction in the mid-1990s without registering them as securities.<sup>216</sup> As insurance companies have developed new products, the state insurance regulators and the SEC have adapted their rules to keep pace with the innovation.<sup>217</sup> However, controversy exists over whether the federal securities laws or state insurance laws should be applied to regulate equity-indexed annuity sales. Most traditional annuities fall outside the securities laws, and the Securities Act expressly disavows insurance regulation, stating that the provisions of the Act do not apply to "[a]ny . . . annuity contract or optional annuity contract, issued by a corporation subject to the supervision of the insurance commissioner, bank commissioner, or any agency or officer performing like functions, of any State or Territory of the United States or the District of Columbia."<sup>218</sup> Equity-indexed annuities, however, have sparked regu-

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209. Crediting formulas typically limit the amount of interest credited by imposing a variety of terms. A "participation rate," for example, limits the investor to a certain percentage of the index's performance. Some equity-indexed annuities may also cap the amount of interest an investor may receive in any given year. See EQUITY-INDEXED ANNUITIES: A COMPLEX CHOICE, *supra* note 203, at 2.

210. IRI FACTBOOK, *supra* note 22, at 34.

211. *Id.* at 35.

212. *Id.*

213. *Beware of Unsuitable Investments for Seniors*, OFF. OF ATT'Y GEN. LORI SWANSON, <http://www.ag.state.mn.us/consumer/ylr/annuitiesunsuitableinvforseniors.asp> (last visited Jan. 8, 2015).

214. See *Am. Equity Inv. Life Ins. Co. v. SEC*, 613 F.3d 166 (D.C. Cir. 2010).

215. See *SEC v. Variable Annuity Life Ins. Co. of Am.*, 359 U.S. 65, 70 (1959).

216. See *Id.* at 13; *Indexed Annuities and Certain Other Insurance Contracts*, *supra* note 21, at 9.

217. See, e.g., *Am. Equity*, 613 F.3d.

218. 15 U.S.C. § 77c(a)(8) (2012).



latory controversy largely because of the difficulty fitting these products into existing classifications.

### 1. Defining and Regulating Annuities

As discussed above, the Securities Act excluded annuities from its scope.<sup>219</sup> But this did not mean that variable annuities could not be regulated as securities. The Supreme Court first considered what Congress intended when it included the term “annuity contract” in the Securities Act in 1959 in *SEC v. VALIC*.<sup>220</sup> In *VALIC*, the Court considered whether a variable annuity subject to the supervision of the insurance commissioner of any State were exempt from the Securities Act and held that they were not exempt.

At the time *VALIC* was decided, variable annuities were new products. Because the first variable annuity contract appeared in 1952,<sup>221</sup> they did not exist when the Securities Act was adopted in 1933. The Court expressed a reluctance to disturb state regulation either through displacement or by superimposing federal requirements because “[w]hen the States speak in the field of ‘insurance,’ they speak with the authority of a long tradition.”<sup>222</sup> However, the Court had to decide what Congress meant when it used the term “annuity” in the Securities Act, at a time when only fixed annuities had existed.<sup>223</sup> States treated variable annuities inconsistently, with some states treating variable annuities as insurance and others not.<sup>224</sup> The Court examined the characteristics of the variable annuity contracts to determine whether they shared traditional insurance characteristics.<sup>225</sup> Historically, the annuities that had been regulated under the insurance laws had been fixed annuities, which did share the traits of traditional insurance products.<sup>226</sup> In determining whether variable annuities should be treated in the same fashion as fixed annuities, the Court concluded that “the concept of ‘insurance’ involves investment risk-taking on the part of the company.”<sup>227</sup> Nevertheless, “absent some guarantee of fixed income, the variable annuity places all the investment risks on the annuitant, none on the company.”<sup>228</sup> Accordingly, the Court held that variable annuities were not exempted from the Securities Act.<sup>229</sup>

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219. See HAZEN, SECURITIES REGULATION, *supra* note 32, § 1.2[3][A].

220. See *Variable Annuity*, 359 U.S. at 65.

221. *Id.* at 69.

222. *Id.* at 68.

223. See *id.* at 69.

224. *Id.*

225. *Id.* at 71–73.

226. *Id.* at 69.

227. *Id.* at 71.

228. *Id.*

229. *Id.* at 73.

Over time, the insurance companies continued to develop new annuity products. In 1967, the Supreme Court was asked to decide whether a flexible-fund annuity was subject to the Securities Act in *SEC v. United Benefit Life Ins. Co.*<sup>230</sup> The flexible-fund annuity was an optional annuity plan which was similar to a variable annuity.<sup>231</sup> In this case, the Court focused less on the shifting of risk and more on “the character the instrument is given in commerce.”<sup>232</sup> The Court examined how the flexible funds were being sold to consumers and found that flexible funds were competing with mutual funds and being sold to consumers under the same value proposition of growth and professional management as mutual funds.<sup>233</sup> In the view of the Court, “[i]t seems eminently fair that a purchaser of such a plan be afforded the same advantages of disclosure which inure to a mutual fund purchaser under §5 of the Securities Act.”<sup>234</sup> Thus, the Court held that the annuities were not exempt annuity contracts under the Securities Act.<sup>235</sup>

In the mid-1980s, the SEC promulgated Rule 151 to create a safe harbor definition of annuity contracts or optional annuity contract under §3(a)(8) of the Securities Act for new products entering the market.<sup>236</sup> The rule was meant to ensure guaranteed investment contracts were exempt from the definition as long as certain conditions were met.<sup>237</sup> Under Rule 151, a contract qualifies for the exemption provided:

- (1) The annuity or optional annuity contract is issued by a corporation (the *insurer*) subject to the supervision of the insurance commissioner, bank commissioner, or any agency or officer performing like functions, of any State or Territory of the United States or the District of Columbia;
- (2) The insurer assumes the investment risk under the contract as prescribed in paragraph (b) of this section; and
- (3) The contract is not marketed primarily as an investment.<sup>238</sup>

Rule 151 also provides the parameters that must be met for the insurer to have adequately assumed the investment risk:

- (1) The value of the contract does not vary according to the investment experience of a separate account;
- (2) The insurer for the life of the contract
  - (i) Guarantees the principal amount of purchase payments and interest credited thereto, less any deduction (without regard to its timing) for sales, administrative or other expenses or charges; and

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230. *United Benefit*, 387 U.S. at 202.

231. *Id.* at 204.

232. *Id.* at 211.

233. *Id.*

234. *Id.*

235. *Id.* at 212.

236. 17 C.F.R. § 230.151 (2013).

237. *Am. Equity Inv. Life Ins. Co. v. SEC*, 613 F.3d 166, 170 (D.C. Cir. 2010).

238. 17 C.F.R. § 230.151(a).

- (ii) Credits a specified rate of interest (as defined in paragraph (c) of this section to net purchase payments and interest credited thereto; and
- (3) The insurer guarantees that the rate of any interest to be credited in excess of that described in paragraph (b)(2)(ii) of this section will not be modified more frequently than once per year.<sup>239</sup>

Rule 151 codified the Court's holdings in *VALIC* and *United Benefit* by specifying that the insurance company must assume the investment risk under the contract and that marketing the annuity as an investment will forfeit the Securities Act exemption.

## 2. The SEC Moves to Regulate Equity-Indexed Annuities

In 2007, the Commission sought to regulate equity-indexed annuities by proposing Rule 151A, which would make it clear that the products fell outside the safe harbor of Rule 151 and within the Commission's jurisdiction.<sup>240</sup> In 2009, the Commission's rulemaking process concluded and it adopted Rule 151A, which excluded from the definition of "annuity contracts or optional annuity contracts," any contract which:

- (1) . . . specifies that amounts payable by the issuer under the contract are calculated at or after the end of one or more specified crediting periods, in whole or in part, by reference to the performance during the crediting period or periods of a security, including a group or index of securities; and
- (2) Amounts payable by the issuer under the contract are more likely than not to exceed the amounts guaranteed under the contract.<sup>241</sup>

Shortly after the Commission adopted Rule 151A, American Equity Investment Life Insurance Co. challenged the rule in the United States Court of Appeals for the D.C. Circuit.<sup>242</sup> Although the court held that the Commission had reasonably interpreted the exclusion for "annuity contracts" as not exempting equity-indexed annuities, it vacated the rule because the Commission had "failed to properly consider the effect of the rule upon efficiency, competition, and capital formation."<sup>243</sup>

Removing doubt that equity-indexed annuities could be regulated under the Securities Act, the court found that equity-indexed annuities were more like securities than annuities that traditionally benefited from the § 3(a)(8) exemption.<sup>244</sup> Retail customers who purchased equity-indexed annuities did not know their annual returns until the end of the year resulting in variability in potential return and risk.<sup>245</sup> As the court noted, "[b]y contrast, an annuity contract falling under Rule 151's exemption avoids this variability by guaranteeing the interest rate ahead of time."<sup>246</sup>

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239. 17 C.F.R. § 230.151(b).

240. See *Am. Equity*, 613 F.3d at 170–71.

241. 17 CFR § 230.151A (a)(1)–(2) (2010).

242. *Am. Equity*, 613 F.3d.

243. *Id.* at 176, 179.

244. *Id.* at 174.

245. *Id.*

246. *Id.*

The court also found that it was not necessary for the Commission to account for the marketing of the product in Rule 151A when determining that the annuity fell outside the safe harbor of Rule 151.<sup>247</sup> When the Commission adopted Rule 151A, it found the inclusion of a marketing factor unnecessary, explaining that “[w]here, as here, the essential characteristic of the product bestows upon that product obvious securities-like qualities, it is reasonable to assume that any marketing of the product would correspondingly be securities-related.”<sup>248</sup> Accordingly, equity-indexed annuities were necessarily marketed as securities-like products because they were more like securities than other annuities. For the foregoing reasons, the court held that the Commission’s interpretation of annuity contract was reasonable.<sup>249</sup>

### 3. Congress Weighs in on Equity-Indexed Annuities

Following the court’s decision, Congress weighed in on the matter when it enacted Dodd-Frank.<sup>250</sup> Title IX, Section 989J, also known as the Harkin Amendment, directs the SEC to treat certain annuity contracts as exempt securities under the Securities Act as long as certain conditions are met. This exemption covers equity-indexed annuities as long as:

- (1) the value of the indexed annuity does not vary according to the performance of a separate account; . . . and
- (3) the indexed annuity is issued in a state that has adopted the Model Suitability Regulation or by an insurer that adopts and implements practices on a nationwide basis for the sale of annuity contracts that meet or exceed the NAIC Model Suitability Regulation.<sup>251</sup>

As discussed above, the NAIC’s Model Regulation tracks FINRA’s suitability standard. It requires that the Broker or Producer have “reasonable grounds for believing that the recommendation is suitable for the consumer on the basis of the facts disclosed by the consumer as to his or her investments and other insurance products and as to his or her financial situation and needs, including the consumer’s suitability information.”<sup>252</sup> The Harkin Amendment assumed that by June 16, 2013, states would have adopted the Model Regulation. However, only about two-thirds of the states have done so.<sup>253</sup> Presently, it is unclear whether the SEC will retain regulatory responsibility over equity-indexed annuities in those states that have not adopted the Model Regulation.

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247. *Id.* at 175.

248. *Id.* at 175–76.

249. *Id.*

250. Dodd-Frank Act, Pub. L. No. 111-203, § 989J, 124 Stat. 1376, 1949-50 (2010).

251. FIO REPORT, *supra* note 63, at 52.

252. NAIC WHITE PAPER, *supra* note 167, § 6.A.

253. *See supra* note 185.

## V. ISSUES REGULATING EQUITY-INDEXED ANNUITY SALES

While Congress, regulators, and industry participants debated how to regulate equity-indexed annuities, financial advisers sold increasing numbers of them. In 1998, the insurance industry sold about \$4 billion of equity-indexed annuities.<sup>254</sup> By 2007, annual sales grew to \$24.8 billion, with the overall number of equity-indexed annuity assets totaling \$123 billion.<sup>255</sup> The industry has continued to grow: in 2012, equity-indexed annuity sales reached \$34.2 billion with the overall number of equity-indexed annuity assets ballooning to \$224.7 billion.<sup>256</sup>

Yet these high sales numbers have long been followed by complaints that the products were being sold to customers who did not need them. In 2008, Commission Chairman Christopher Cox remarked that many equity-indexed annuities “appear to have been marketed to investors who are least able to scrutinize the details” and that many were sold to “older Americans who are simply in many cases not suitable purchasers.”<sup>257</sup> Some argue that equity-indexed annuities’ abnormally high commissions induce Producers to sell the products to persons who do not need them.<sup>258</sup> According to one report, the current average sales commission paid by insurance companies to their agents for selling equity-indexed annuities is 6%.<sup>259</sup> However, the sales commissions for certain equity-indexed annuities may be even higher—ranging up to 12%.<sup>260</sup> Additional incentives may also exist; for example, some insurance companies have rewarded Producers with free trips to Disney World in exchange for selling equity-indexed annuity products.<sup>261</sup> In many ways, these concerns about equity-indexed annuity sales mirror larger concerns about the business of giving investment advice generally.

A. *Early Marketing and Sales*

Equity-indexed annuities have been sold in troubling ways. At one annuity sales training seminar presented by “Annuity University,” the *Wall Street Journal* found cause for concern.<sup>262</sup> At the training, attendees were

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254. See Indexed Annuities and Certain Other Insurance Contracts, *supra* note 21, at 8.

255. *Id.* at 9.

256. IRI FACTBOOK, *supra* note 22, at 164.

257. Cox, *supra* note 27.

258. Leslie Scism, *Fixed Indexed Annuities Merit Caution*, WALL ST. J. (Aug. 16, 2013, 8:00 PM), <http://online.wsj.com/news/articles/SB10001424127887323455104579014792319250018>.

259. *Id.*

260. Zeke Faux & Margaret Collins, *Indexed Annuities Cap Gains, Obscure Fees as Sellers Earn Trip to Disney*, BLOOMBERG (Jan. 20, 2011, 12:01 AM), <http://www.bloomberg.com/news/2011-01-20/indexed-annuities-obscure-fees-as-sellers-earn-trip-to-disney.html>.

261. *Id.*

262. Ellen E. Schultz & Jeff D. Opdyke, *At Annuity University, Agents Learn How to Pitch to Seniors*, WALL ST. J. (Jul. 2, 2002), <http://online.wsj.com/news/articles/SB1025561802229705600>.

told that to sell to senior citizens, they should “[t]reat them like they’re blind 12-year-olds” and that they should expect them to “buy based upon emotions! Emotions of fear, anger and greed.”<sup>263</sup> Trainees were coached to avoid giving technical descriptions of annuities.<sup>264</sup> Instead, they were told to give simpler answers.<sup>265</sup> Tyrone Clark, the instructor at the training seminar claimed that instead of the “technical answer,” annuity salespersons should give “the senior answer. Tell them it’s like a CD—it’s safe, it’s guaranteed.”<sup>266</sup> This, of course, is simply not true. Annuities and certificates of deposit are vastly different products. At Annuity University, trainees were taught to generate fear and make sales.<sup>267</sup> They were told to “[t]oss hand grenades into the advice to disturb the seniors” and that selling required “putting a pitchfork in their chest.”<sup>268</sup>

### B. *The 2005 FINRA Notice about Equity-Indexed Annuities*

As concerns grew, FINRA issued a Notice to its Members in 2005, addressing the responsibility of Brokers and firms when selling equity-indexed annuities that had not been registered as securities.<sup>269</sup> Specifically, FINRA was concerned with the sales materials associated with unregistered equity-indexed annuities because they did not fully and accurately describe the products. FINRA highlighted specific claims found in certain marketing materials. Some of the claims included:

- What if the market goes down and you would lose nothing? The market goes up—you gain!
- A Win/Win Investment Vehicle!
- How Your Retirement Funds Can Have: Security of Principal, Higher Than CD Rates of Interest, Opportunity for Growth (No Losses)
- Pick up where Social Security leaves off with NEW tax-deferred annuities . . . featuring . . . 2 indexed accounts linked to a popular stock market index.
- If you’re looking for upside potential and no market downside look no further than [name of equity-indexed annuity]. This fixed annuity . . . enables you to make the most of S&P 500 Index gains . . .
- Growth Potential *without* Market Risk.<sup>270</sup>

Remarking on these advertisements, FINRA noted that these sales materials could confuse or mislead investors.<sup>271</sup> Given the products’ com-

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263. *Id.*

264. *Id.*

265. *Id.*

266. *Id.*

267. *Id.*

268. *Id.*

269. NAT’L ASS’N. OF SEC. DEALERS, EQUITY INDEXED ANNUITIES, NOTICE TO MEMBERS 05-50 (2005), available at <http://www.finra.org/web/groups/industry/@ip/@reg/@notice/documents/notices/p014821.pdf>.

270. *Id.*

271. *Id.*

plexity, FINRA was also concerned that some Brokers “might have difficulty understanding all of the features of the product and determining the extent to which those features meet the needs of the customer.”<sup>272</sup>

At the time, FINRA took no position on whether equity-indexed annuities were securities. However, much rode on the products’ classification. If the products were classified as securities, the law imposed extensive supervisory obligations on firms with Brokers selling equity-indexed annuities. If the products were not securities, the sales could be classified as outside business activities and would have to be supervised accordingly.<sup>273</sup>

### C. *The NASAA Survey & the Commission’s First Senior Summit*

In 2006, the North American Securities Administrators Association (“NASAA”) conducted a survey of state securities regulators.<sup>274</sup> The survey found that 44% of investor complaints received by regulators were made by senior investors.<sup>275</sup> The survey also found that unregistered securities, variable annuities, and equity-indexed annuities were the most pervasive financial products involved in senior investment fraud.<sup>276</sup> Cases involving variable or equity-indexed annuities represented an estimated 65% of the caseload in Massachusetts and 60% of the caseload in Hawaii and Mississippi.<sup>277</sup>

NASAA presented much of this information to the Commission at its first Seniors Summit in July 2006.<sup>278</sup> In its presentation, NASAA made clear that its concerns about equity-indexed annuities were not about whether the products should be sold to the public, but about the ways in which the products were “being pitched aggressively to seniors through investment seminars.”<sup>279</sup> In particular, NASAA was concerned that investors were not “always told about high surrender charges for early withdrawal, the potential of exposure to market risk, and the steep sales commissions agents often earn when they move investors into these products.”<sup>280</sup>

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272. *Id.*

273. *Id.*

274. *NASAA Survey Shows Senior Investment Fraud Accounts for Nearly Half of all Complaints Received by State Securities Regulators*, N. AM. SEC. ADMINISTRATORS ASS’N (July 17, 2006), available at <http://www.nasaa.org/7620/nasaa-survey-shows-senior-investment-fraud-accounts-for-nearly-half-of-all-complaints-received-by-state-securities-regulators/>.

275. *Id.*

276. *Id.*

277. *Id.*

278. See Patricia D. Struck, *NASAA Statement at SEC Seniors Summit*, N. AM. SEC. ADMINISTRATORS ASS’N (Jul. 17, 2006), <http://www.nasaa.org/860/nasaa-presidents-state-ment-at-sec-seniors-summit/>.

279. *Id.*

280. *Id.*



#### D. The Dateline NBC Investigation

In 2008, a Dateline NBC investigation into equity-indexed annuity sales found a number of issues with how the products were being sold to retail consumers.<sup>281</sup> In particular, Dateline focused on how equity-indexed annuities were being sold through so-called Free Lunch seminars.<sup>282</sup> To induce people to attend, the seminar leaders sent invitations to an educational seminar to retirees and provided free food. According to a study by the Commission that focused on free lunch seminars presented by brokerage firms, 100% of the seminars reviewed were designed primarily as sales seminars and not to provide public education.<sup>283</sup>

Free Lunch seminars were often held at upscale hotels, restaurants, retirement homes, and golf courses and offered invitees attractive inducements, such as door prizes and prizes like tote bags and cruises. The seminar advertisements and mailers were often designed to imply urgency, using phrases such as “Act Now!” and “Seating is Limited!”<sup>284</sup> Some of the advertisements and mailers used scare tactics that targeted seniors, such as, “If you’re retired, *YOU’RE A TARGET* and you cannot afford to miss this workshop!” and “How to Protect your Nest Egg from The Retirement *Vultures*.”<sup>285</sup> The seminars had titles such as “Senior Financial Survival Seminar” and “Senior Financial Safety Workshop.”<sup>286</sup> The financial advisors presenting the seminars sometimes used titles that represented that they had some special training, knowledge, or certification, such as “Certified Senior Advisor,” “Elder Care Asset Protection Specialist,” or “Chartered Retirement Planning Counselor.”<sup>287</sup> Free Lunch seminars continue to be an issue for retail customers. Although not all seminars sell equity-indexed annuities, Free Lunch seminars are widespread and about 64% of investors surveyed by FINRA in 2013 in the 40+ age group received at least one invitation to a Free Lunch seminar.<sup>288</sup>

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281. See Chris Hansen, *Tricks of the Trade* (NBC television broadcast, Apr. 13, 2008), available at [http://www.nbcnews.com/id/24095230/ns/dateline\\_nbc/t/tricks-trade/#.U4TbM\\_Id](http://www.nbcnews.com/id/24095230/ns/dateline_nbc/t/tricks-trade/#.U4TbM_Id) (broadcast transcript) [hereinafter *Dateline Transcript*].

282. *Id.*

283. See OFFICE COMPLIANCE INSPECTIONS & EXAMINATIONS, U.S. SEC. & EXCH. COMM’N *Protecting Senior Investors: Report of Examinations of Securities Firms Providing “Free Lunch” Sales Seminars* (Sept. 2007), available at <http://www.sec.gov/spotlight/seniors/freelunchreport.pdf>.

284. *Id.*

285. *Id.*

286. *Id.*

287. *Id.*

288. *Id.* Although a third of those surveyed said they attended a seminar, only 4% had lost money as a result. *Id.* This 4% figure likely understates the true scope of senior losses. Seniors purchasing equity-indexed annuities will only lose principal when forced to withdraw funds before the surrender charge period expires. Seniors may be less aware of the opportunity cost losses flowing from their purchases of these products. By owning an equity-indexed annuity instead of a portfolio of securities, seniors may accumulate substantially less wealth than they would had their assets been appropriately allocated.

Although anecdotal, Dateline NBC's investigation into one equity-indexed annuity sales seminar at an Alabama steak house found the salesperson making troubling claims and seemingly attempting to scare attendees into purchasing an equity-indexed annuity.<sup>289</sup> After claiming that he had "no agenda when [he] see[s] people," the equity-indexed annuity salesman began by questioning whether bank deposits guaranteed by the Federal Deposit Insurance Corporation ("FDIC") were safe.<sup>290</sup> He claimed that the FDIC's financial strength had been rated and received an "F-minus" mark.<sup>291</sup> Shortly afterward he claimed that with an equity-indexed annuity, the attendees' accounts would never go down and could only go up.<sup>292</sup> The salesperson did not mention that seniors could lose up to 18% if they needed to remove their money before the multi-year surrender period expired.<sup>293</sup> The Dateline transcript also does not reveal whether the salesperson disclosed the amount he would receive as a sales commission.

#### E. *Continuing Investigations*

Concerns about unsuitable and exploitative insurance sales have caused some state regulators to take action. As explained above, state securities administrators often do not have direct regulatory authority over Producers because they are regulated by the insurance commissioners.<sup>294</sup> However, when recommending that an investor purchase an insurance product, such as a fixed annuity or an equity-indexed annuity, Producers will sometimes recommend that investors liquidate other investments. Depending on the advice given, the Producer may stray across the regulatory boundary between insurance and securities and act as unregistered investment adviser by advising a client to sell securities to purchase insurance.

In 2008, the Missouri Securities Division pursued an insurance agent for selling three fixed annuities and one equity-indexed annuity to an elderly investor.<sup>295</sup> The insurance agent, Terry Simpkins, recommended the liquidation of the majority of the securities in the investor's two brokerage accounts to fund the purchase of two of the annuities.<sup>296</sup> The other two annuities were funded by the liquidation of bank certificates of deposit.<sup>297</sup> Simpkins received commissions from the sale of the annuities.<sup>298</sup> The Se-

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289. See *Dateline Transcript*, *supra* note 281.

290. *Id.*

291. *Id.*

292. *Id.*

293. *Id.*

294. See generally *supra*, Part III.B.

295. Simpkins, Case No. AP-08-11 (State of Mo. Office of Sec'y of State, Dec. 11, 2009).

296. *Id.*

297. *Id.*

298. *Id.*

curities Commissioner considered this compensation for investment advice without being registered as an investment adviser as a violation of the Missouri state statutes.<sup>299</sup> Accordingly, the Enforcement Division sought civil penalties totaling \$30,000 for multiple statutory violations.<sup>300</sup>

In 2010, the Illinois Securities Department pursued an insurance agent, Jeffrey Hum, for selling equity-indexed annuities to elderly investors.<sup>301</sup> One of the investors had a \$1 million dollar diversified portfolio invested in stocks and bonds, which Hum reallocated into four equity-indexed annuities, liquidated, and then reinvested in other equity-indexed annuities.<sup>302</sup> Hum engaged in similar conduct on behalf of an elderly couple.<sup>303</sup> The Secretary of State found that Hum's activities constituted the activities of an investment adviser and that he had failed to register as an investment adviser representative in violation of Illinois law.<sup>304</sup> As a result, he was permanently prohibited from offering or selling securities in Illinois.<sup>305</sup>

State enforcement responses have targeted insurance companies as well as Producers. State regulators in California, Minnesota, and other states settled cases with insurance companies involving allegations that their representatives were misleadingly selling equity-indexed annuities.<sup>306</sup> For example, Allianz Life Insurance Company of North America, a market leader in equity-indexed annuities, settled a host of cases with state regulators alleging that it had incentivized unsuitable sales.<sup>307</sup> Although Allianz did not admit to any wrongdoing in the settlement, as part of the settlement it agreed to maintain an "Agent Oversight Program" to review its agents' behavior.<sup>308</sup>

## VI. A FRAMEWORK FOR REFORM

The divergent standards and regulatory structures detailed above reveal that the current retail customer protections are insufficient and generate unnecessary confusion and complexity. A federal statute—an Investment Advice Act—would provide much needed uniformity and consistency in this area. The driving principle behind the Act should be that personalized investment advice should be regulated consistently, rather than being regulated based on compensation structure or the type of prod-

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299. *Id.*

300. *Id.*

301. Hum, File No. 0800543 (State of Ill. Sec'y of State Sec. Dep't, Aug. 23, 2010).

302. *Id.*

303. *Id.*

304. *Id.*

305. *Id.*

306. Scism, *supra* note 258.

307. *Id.*

308. ALLIANZ LIFE INS. CO. N. AM., REGULATORY SETTLEMENT AGREEMENT 7 (2012), available at [http://www.floir.com/siteDocuments/ALLIANZ\\_June25RSA.pdf](http://www.floir.com/siteDocuments/ALLIANZ_June25RSA.pdf).

uct being sold. To guide efforts to frame such an Act, Part VI sketches considerations in broad strokes. At least, great care should be taken to ensure that any such federal act has: (A) a sufficiently broad scope; (B) an administrative agency charged with coordinated implementation, interpretation, and enforcement; and much needed reforms to (C) compensation structures and disclosures, and (D) sales practice regulations.

### *A. Scope Considerations*

To prove effective, an Investment Advice Act must have a sufficiently broad scope to cover financial advisers providing investment advice to retail customers. Many life insurance products that are sold for investment purposes rather than insurances purposes should fall within the scope of the Act. For example, the Act should cover advice about equity-indexed annuities, whole life insurance, universal life insurance, variable life insurance, variable annuities, and fixed annuities.<sup>309</sup> Instead of regulating by compensation structure or particular type of product sold, the Act should apply to financial advisers—persons who hold themselves out as providing investment advice to the public. At the least, the definition of financial adviser should encompass today's Brokers, Advisers, and Producers selling life insurance products with investment objectives.

However, an Investment Advice Act should not attempt to regulate every insurance transaction. For instance, Producers sell a wide range of products, including life insurance products and property and casualty insurance products. There seems no reason to extend the Act to cover property and casualty insurance products, which do not implicate the same concerns that the sale of other certain insurance products do.

### *B. Appropriate Administrative Consolidation, Oversight & Enforcement*

Coherent administrative oversight of an Investment Advice Act will reduce coordination costs and improve investor protection. Yet, should the Act be administered by a particular existing federal agency or should a new administrative agency be created? While a strong case could be made for the Consumer Financial Protection Bureau, the Commission is the leading candidate to assume authority as the primary federal administrative agency enforcing an Investment Advice Act.<sup>310</sup> In the view of the authors, the Commission should at least be tasked with broad oversight authority for licensing, examinations, and enforcement.<sup>311</sup> Notwithstanding the proposal for a federal system of regulation, there remains a role for state regulators within these areas.

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309. Variable life insurance and variable annuities are hybrid security products that require individuals to be both insurance licensed and securities licensed.

310. As insurance has historically been regulated solely at the state level, no federal agency is adequately equipped to assume the task.

311. Under this regulatory scheme, the Commission may delegate day-to-day oversight to a self-regulatory body, such as FINRA; however, the Commission itself would retain primary responsibility for implementation of the statutory and regulatory scheme.

### 1. Licensing & Examinations

A coherent and harmonious national regulatory framework offers substantial benefits. Today, Advisers, Brokers, and Producers are qualified and licensed by separate entities even though their advice concerns the same subject. These entities impose different standards for persons to qualify to give financial advice. Generally, Brokers and Producers must pass exams to become licensed.<sup>312</sup> The exams test knowledge of the rules that the individual will be subject to and the basics about the products that may be sold with the license.<sup>313</sup> As discussed in Part III.A.1 *supra*, Advisers need only register with the Commission or the states in which they will be doing business, depending on the size of their operation.

An Investment Advice Act should provide for uniform qualification, examination, and licensing of financial advisers and administration of examinations by a national regulator, such as FINRA. Because competent investment advice requires a broad understanding of the modern financial landscape, persons authorized to give investment advice under the Act should be required to demonstrate a certain minimum understanding of the characteristics of different asset classes. At a minimum, financial advisers should be required to understand basic financial products and the wide range of possible investments available to clients. For example, individuals should be competent to provide advice about the general characteristics of stocks, bonds, mutual funds, and annuities. Establishing a minimum competency baseline for financial advisers would solve many of the current problems flowing from our current, fragmented structure. As discussed in Part III *supra*, Producers today may not advise retail customers to sell securities in order to purchase insurance products if they are not licensed to give advice about securities. When it is in a customer's best interest, a financial adviser should be able to recommend moving assets from one class of investment to another without running afoul of the law. This may only be done if all persons qualified under an Investment Advice Act have demonstrated core competencies and an understanding of the roles played by different asset classes.

Additional exams should also be mandated, as appropriate, to qualify financial advisers to recommend specific categories of products, such as low-priced securities, options, annuities, and municipal securities. This would serve to ensure basic subject matter knowledge and competency. While a national regulator, such as FINRA, should serve as the central licensing authority to establish and administer the exams, each state should retain the ability to approve or deny registration in the individual state.

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312. See *FINRA Registration and Examination Requirements*, FIN. INDUS. REGULATORY AUTH., <http://www.finra.org/Industry/Compliance/Registration/QualificationsExams/Qualifications/p011051> (last visited Nov. 16, 2014).

313. See, e.g., *id.*; NY Insurance Exam Outline, PROMETRIC, <https://www.prometric.com/en-us/clients/NewYork/Pages/exam-content.aspx> (last visited Nov. 16, 2014).

## 2. Enforcement

Regulations only have meaning if they are enforced. Today, different enforcement mechanisms police the behavior of Brokers, Advisers, and Producers. While “FINRA conducts examinations of 55 percent of all broker-dealers every year,” Advisers are examined much less frequently.<sup>314</sup> Because states regulate Producers, there is greater variation nationally. These oversight disparities would be greatly reduced by subjecting all financial advisers to the same regime. While the task may be too great for the Commission’s current resources, FINRA’s resources would effectively supplement the Commission’s authority. Already overseeing Brokers, FINRA could be charged with the primary responsibility for overseeing all financial advisers giving investment advice. Because FINRA’s current country-wide uniform system of regulation now oversees the brokerage industry, much of what this Article proposes would simply extend and slightly modify the existing system of regulation.

To achieve its core purpose, an Investment Advice Act need not displace the extensive system of state regulation currently in effect. Rather, this structure would overlay the current state system in the same way the Securities Act and the Exchange Act overlaid the existing state layer of securities regulation in the 1930s. This federal system would create a national floor, so to speak, with states retaining their ability to enforce the regulations and discipline financial advisers within their jurisdiction.

### C. Compensation Reforms

Sensible compensation reforms would more closely link compensation to services provided. Compensation has long been a source of conflict for individuals providing investment advice.<sup>315</sup> The transaction-based fees secured by Brokers and Producers and the asset-based fees secured by Advisers create conflicts, albeit of a different sort. The proliferation of indirect fees for investment advice further complicates today’s compensation structures. For example, customers may not pay any up-front charges when they purchase an annuity, but the Brokers and Producers may still receive a commission.<sup>316</sup> The customer may mistakenly believe that the Broker or the Producer has not made any money from the transaction, when in reality they have secured a rather high fee, perhaps 7%. When the Exchange Act and the Advisers Act were enacted, compensation was more closely tied to the services offered. Brokers were paid commissions to execute transactions and Advisers were paid for advice.<sup>317</sup> It was ex-

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314. See Wrona, *supra* note 124, at 42.

315. See COMMITTEE ON COMPENSATION PRACTICES, U.S. SEC. & EXCH. COMM’N, REPORT OF THE COMMITTEE ON COMPENSATION PRACTICES 7 (1995), available at <http://www.sec.gov/news/studies/bkrcomp.txt>.

316. See NASAA *Informed Investor Alert: Annuities*, N. AM. SEC. ADMINISTRATORS ASS’N, <http://www.nasaa.org/2692/informed-investor-alert-annuities/>.

317. Lazaro, *supra* note 14, at 398.

PLICITLY assumed that Brokers were not receiving any compensation for the advice they were giving, to the extent they were giving customers any advice. Today, that distinction no longer exists.<sup>318</sup> Brokers are expected to give advice, such as a recommendation to purchase an investment. The commission compensation that Brokers receive must cover this service in addition to the execution of the transaction, especially in light of the fact that most of their time is spent providing advice, not executing transactions.<sup>319</sup> Producers likewise often receive compensation indirectly from the insurance companies for the products they sell.<sup>320</sup>

Astoundingly, the current system defines the parameters of the relationship between investment adviser and retail customer primarily on the basis of the manner in which fees are charged.<sup>321</sup> When an individual charges an asset-based fee, the law recognizes that the individual is being paid for advice.<sup>322</sup> When the same individual charges a commission, the law effectively pretends that the individual is being paid for executing a transaction without any further investigation into the relationship between the investor and the individual providing advice. These criteria are flawed. The parameters of the relationship should not be defined by the fee charging method.

An Investment Advice Act should solve this problem by tying compensation to the services offered rather than the product sold. The duties owed to the customer should not be artificially determined solely on the basis of the type of fee charged to the retail customer. To make the nature of the payment clearer, the current commission-based structure should be fundamentally restructured to limit most indirect payments for investment advice. Rather, fees paid for investment advice should be separated from the costs associated with the transactions and paid separately. To regulate the financial advice business within their own borders, other nations have already moved in this direction: for example, the United Kingdom and Australia recently introduced radical reforms to govern the provision of financial advice.<sup>323</sup> The new Australian structure expressly requires regulated persons to act in the best interests of their clients, bans certain forms

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318. *Id.* at 382.

319. *See* FIDUCIARY STUDY, *supra* note 13, at 10–11.

320. Leslie Scism, *Insurance Fees, Revealed*, WALL ST. J. (Mar. 30, 2012, 5:08 PM) <http://online.wsj.com/articles/SB10001424052702304177104577305930202770336>.

321. *See* Lazaro, *supra* note 14, at 413 (arguing that the standards for investment advice should not vary based on how the fee is charged).

322. *See* Fin. Planning Ass'n v. SEC, 482 F.3d 481 (D.C. Cir. 2007).

323. Francis J. Facciolo, *Introduction*, 87 ST. JOHN'S L. REV. 297, 299 (2013) ("The United Kingdom and Australia have also been pursuing radical reforms of the regulation of financial advice given to retail customers. The purpose of these reforms is to restrict compensation practices for investment advisers that might influence the advice that they give to retail customers because of their compensation arrangements with financial product producers.").



of conflicted compensation, and requires clients to affirmatively opt-in to ongoing fees.<sup>324</sup>

Bringing these fees into the light would do much good. It would reduce the incentive for financial advisers to recommend one product over another on the basis of fees because the fees involved would be more transparent. Complexity and obscurity in financial products tends to favor the interests of issuers over retail customers.<sup>325</sup> Still, it may be appropriate to pay financial advisers an asset-based fee if they provide advice on an on-going basis. To the extent financial advisers are paid by issuers of products, the precise amounts of those payments must be fully and transparently disclosed to the retail customer prior to the completion of the sale. Such payments present potential conflicts of interest that should be disclosed to retail customers.

#### D. *Consistent Standards for Advisory Services*

Today, Advisers, Brokers, and Producers are held to different sales practice standards. Advisers are held to a federal fiduciary standard requiring them to act in the best interests of their clients and avoid or disclose most conflicts of interest. Brokers are held to a suitability standard: they must recommend investments that are appropriate for their clients. Most conflicts of interest are disclosed to the customer, many at the conclusion of the sale of the investment. Producers are generally held to a similar standard if they are selling an annuity; however, depending on the state they are in they may be held to a lesser standard, including no standard at all.

An Investment Advice Act should impose new standards for financial advisers based on the services offered and the advice-giver's relationship with to the retail customer. There should be a more coherent framework with three different tiers of obligations for most financial advisers. Within this framework, conflicts of interest should be handled differently for each service tier.

##### 1. Tier 1: Transaction-Based – Execution-Only

Within the first tier, the transaction-based – execution-only tier, financial advisers would only provide execution services. In other words, the retail customer would not be given any investment advice. For example, this tier would include firms that offer online accounts where the retail customer places trades based on his or her own research. Presumably, each trade placed would incur a fee based on the costs to the firm to exe-

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324. Richard Batten & Gail Pearson, *Financial Advice in Australia: Principles to Prescription; Managing to Banning*, 87 ST. JOHN'S L. REV. 511 (2013).

325. FIN. INDUS. REGULATORY AUTH., REPORT ON CONFLICTS OF INTEREST 22 (2013) ("In general, the increased complexity of such debt products can favor issuers over investors . . .").

cute the transaction. This should be the lowest cost option for retail customers.

Within this tier, financial firms should be held to a very limited fiduciary duty in the execution of the transaction. This would encompass the current concepts of best execution, fair prices reasonably related to the market, full disclosure as to the terms of execution, and disclosure of any potential conflicts of interest, such as payment for order flow, market-maker services, or principal transactions.

## 2. Tier 2: Transaction-Based – Advice

Within the second tier, the transaction-based – advice tier, financial advisers would provide similar execution services to Tier 1, but retail customers would also be able to obtain advice in connection with transactions from an appropriately licensed financial adviser. With this tier, the compensation would be transaction-based. There would not be any expectation of an ongoing relationship between the financial adviser and the retail customer. The financial adviser would be held to a limited fiduciary standard that would encompass the same duties as Tier 1 but with additional duties. In this tier, recommendations to buy or sell investments should be in the best interests of the retail customer, and the financial adviser should be required to place the retail customer's interests ahead of the adviser's own interests.

Conflicts of interest would inevitably still arise and how financial advisers deal these conflicts would depend on the type of conflict. Any Investment Advice Act should take great care to minimize conflicts of interest flowing from transaction-based fees. While clearer and more transparent disclosure of fees for advisory services would do much to reduce conflicts of interest, adequate supervision structures will need to be maintained to police behavior.

## 3. Tier 3: Full Service – Ongoing Management

The third and highest tier, the full service – ongoing management tier, would provide for the highest level of service by financial advisers and duties owed to customers. Financial advisers operating at this level would provide on-going management services, advice, and monitoring of the investments within the retail customer's account. Asset-based compensation would be permissible within this tier of service. To avoid confusion, firms should not be permitted to hold themselves out as full service unless all of their affiliated personnel were held to the highest standards. The duties of the first two tiers would be incorporated here and the financial adviser would be held to the highest fiduciary duty, requiring the adviser to put the retail customer's interests ahead of his own. Additionally, the financial advisers would be required to monitor the retail customer's account and make recommendations as appropriate to address changes in market conditions.

To the extent possible, conflicts of interest should be avoided entirely. Persons providing services within this tier should not be permitted to receive additional compensation from issuers of products in addition to the compensation received from the retail customers for managing their accounts. Financial advisers should also be required to disclose other conflicts, such as their firm having inventory in the same investment, and receive the retail customer's acknowledgement of a conflict at the time of the recommendation, not when the sale is completed.

It may also be appropriate to hold financial advisers operating within a lower tier to the standards of a higher tier. Financial advisers should not be able to operate within one tier while marketing and holding themselves out as providing a higher tier of services. If a financial adviser's conduct would lead a reasonable retail customer to believe that he or she was engaging an individual in a higher tier, the higher level of standards should apply.

## VII. CONCLUSION

Current debates about whether Brokers should be bound by the same fiduciary duties as Advisers largely miss the insurance side of the story. In part, the partitioning of the securities and insurance businesses into separate regulatory regimes may be the cause. While these separate regulatory regimes may have once made sense, their wisdom now appears suspect. New financial products, such as equity-indexed annuities, challenge the traditional divisions between securities and insurance products. As these worlds increasingly intermingle, the need for a coherent regulatory structure will increase.

The securities laws were initially enacted to protect investors, which they achieved through disclosure and regulation that set forth standards of conduct. Unfortunately, retail customers remain at risk, indicating that either disclosure is ineffective or the standards of conduct themselves are inadequate. The insurance laws, in contrast, have unclear objectives and lack uniformity across the country in how they protect retail customers. The result is investment advice arbitrage: a financial adviser is able to determine what standard of conduct the adviser will be held to by choosing to sell the client a particular investment product or offering the client a particular fee structure, regardless of what investment product or fee structure is best for the client. This state of regulation is not investor protection; it has abandoned the maxim President Roosevelt put forth 80 years ago and returned the investment advice industry to the pre-Depression era of *caveat emptor*.

This Article proposes a solution, an Investment Advice Act, that will eliminate the opportunity for arbitrage by unifying the systems of oversight into a single scheme of legislation. Under this solution, financial advisers will no longer be able to manipulate regulation structures to their advantage rather than that of their clients. Under the proposed Investment Advice Act, a financial adviser's standards of conduct will now be

directly tied to the level of investment advice given to the retail customer and will no longer be connected to the product sold or the compensation received. Under this new scheme, the financial adviser's duty will be clear before the financial adviser speaks, rather than determined after the advice has been given and a product or fee structure chosen. In some respects, the financial industry already supports changes to the standards governing Brokers and Advisers. The Securities Industry and Financial Markets Association ("SIFMA") supports the adoption of a uniform fiduciary standard; however it remains concerned about the potential costs associated with adopting such a standard.<sup>326</sup> SIFMA has not yet contemplated the adoption of a standard which would also integrate insurance products. The Investment Advice Act would address some of these concerns about the costs associated with uniform standards by preserving options for the financial advisers. Financial advisers will be able to offer low cost options, such as execution-only services or transaction-based advice. The proposed Act is not a one-size-fits-all model, but rather, one that allows tailoring to several different business models.

As the Baby Boomer generation ages and depends more on financial advisers to manage its wealth, the proper regulation of investment advice becomes more urgent. While the task of reforming the regulation of investment advice in the United States is monumental, reforms have been successfully adopted abroad.<sup>327</sup> There is hope that, with investor advocates and the financial industry working together, successful reforms may be adopted in the United States as well.

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326. See SIFMA Comment Letter on Duties of Brokers, Dealers and Investment Advisers (July 5, 2013), available at <http://www.sec.gov/comments/4-606/4606-3128.pdf>

327. See Part VI.C. above.